‘PERSPECTIVE OF ACCOUNTING’
PRINCIPLES, RULES, ETHICS & CULTURE

Md. Azim
Lecturer, Department of Business Administration, World University of Bangladesh
azimbikrom@gmail.com

Helaluddin Ahmed
Lecturer, Department of Business Administration, World University of Bangladesh
hua.sujan@gmail.com

Abstract
The purpose of this study was to explain how Principles-Based accounting standard and Rules-Based accounting standard impact on accounting practices and how Ethics and Culture are important in influencing accounting practices. The study revealed that Principles-Based accounting standard is conceptual basis and needs professional judgment and Rules-Based accounting standards contain details rules which increase complexity and tendency of aggressive reporting and strong audit committees as well as extensive scrutiny by the government and regulator are necessary to get desired benefit from it. Since both the Principles-Based and Rules-based accounting standard have some limitations, so it is necessary to trade-off between these two standards. It is also necessary to infuse the accounting practices with professional ethics and that will only be possible when all the stakeholders create and follow culture of ethics. Thus faithful representation of all transactions will be possible which will ultimately lessen the practices of accounting manipulation.

Keywords: Principles-Based Accounting Standard, Rules-Based Accounting Standard, Ethics in Accounting, Culture, Accounting Manipulation
INTRODUCTION
It is common to ask whether Principles-Based standard is better or Rules-Based standard. Some argue that the rules based US GAAP approach is better while others argue that the principles based IFRS is better. To answer it, there is a necessity to know about the characteristics as well as advantages and disadvantages of both Principles-Based standard and Rules-Based standard. That is why this study covers the mentioned matters.

The objective of this study is to show that to get desired benefit (i.e., faithful representation of all transaction) from Principles-Based or Rules-Based standard, there is a necessity to trade-off between both the standard and it is also needed to infuse professional ethics with the standards. The study is based on critical review of scholarly articles.

EXISTING LITERATURE
The following characteristics regarding Principles-based and Rules-based accounting standard taken from various articles of different scholars:

**Characteristics of Principles-Based Accounting Standard**
Principles-Based standard is less precise i.e., lacking detailed guidance. SEC (2003) opines, “Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors.”


Principles-based standard provides a conceptual basis. Shortridge and Myring (2004) say, “Principles-based accounting provides a conceptual basis for accountants to follow instead of a list of detailed rules.”


Principles-Based standard prevent aggressive reporting. Agoglia et al. (2011) show, “Financial statement preparers are less likely to report aggressively when applying a less precise (more principles-based) criterion than when applying a more precise (more rules-based) criterion.”

Principles-Based standard has the potentiality to make different interpretations for similar transactions. Forgeas (2008) says, “The inherent characteristic of a principles-based framework is the potential of different interpretations for similar transactions.”
Principles-based standard is clear and concise. SEC (2003) opines, “Principles-based accounting standards are typically characterized as containing clear statements of intent but lacking detailed implementation guidance.”

Principles-Based standard produce second guessing. Agoglia et al. (2011) show, “The less precise the standard, the more concerned preparers are about second-guessing and possible costs imposed through regulation and litigation.”

**Characteristics of Rules-Based Accounting Standard**


In Rules-Based standard there is a tendency to report aggressively. Agoglia et al., (2011) says, “But preparers asked to apply a more precise standard are less likely to report aggressively in the presence of a strong audit committee than in the presence of a weak audit committee.” Berkowitz and Rampel (2002) states, “The big firms have concocted all kinds of slippery methods that enable companies to comply with the exact letter of the rules while still managing to mislead investors.”

By relying so intensely on rules, rather than principles, CPAs abdicated their responsibility to use their professional judgment (Berkowitz, A., and Rampell, R., 2002).

Rules-Based standard is specific. Nelson (2003, 91) defines “rules” as “specific criteria, ‘bright-line’ thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc.

The SEC (2003) opines that principles-only standards hurt comparability and consistency as interpretations of the principles vary across time and companies.
ADVANTAGE AND DISADVANTAGE OF PRINCIPLES-BASED AND RULES-BASED STANDARDS

From the review of related articles the following advantages and disadvantages are gathered:

Advantage of Principles-Based Accounting Standard:
- Principles-Based standard can be practical for a variety of circumstances.
- Principles-Based standard can dampen the aggressive financial reporting.
- Principles-based standards are the perceived solution to problems caused by rules-based standards.
- By applying professional judgment in Principles-Based standard, it is possible to result more meaningful and informative financial statements
- There is no scope for aggressive reporting with Principles-Based standard.

Disadvantage of Principles-Based accounting standard:
- Principles-based standards provide few exact rules and little implementation guidance.
- The problem with principles-based guidelines is that lack of guidelines can produce unreliable and inconsistent information that makes it difficult to compare one organization to another
- Principles-based standards are without bright lines which may force preparers to look beyond the form of the transaction to concentrate on its economic substance
- Principles-based standard “could lead to abuse, whereby the principles in accounting standards are not applied in good faith consistent with the intent and spirit of the standards.
- Principles-based standards are inconsistent because it requires significant guidance for management judgment.

Advantage of Rules-Based Accounting Standard:
- Many accountants favor the prospect of using rules-based standards, because in the absence of rules they could be brought to court if their judgments of the financial statements were incorrect.
- Those favoring rules-based standards argue that the detailed guidance contained in such standards reduces diversity in application of the standards, thereby enhancing financial statements’ consistency and comparability.
- Standards without bright lines may force preparers to look beyond the form of the transaction to concentrate on its economic substance
• Companies want detailed guidance because those details eliminate uncertainties about how transactions should be structured, and auditors want specificity because those specific requirements limit the number of difficult disputes with clients and may provide defense in litigation.
• Securities regulators want detailed guidance because those details are thought to be easier to enforce.

Disadvantage of Rules-Based Accounting Standard:
• The complexity of rules can cause unnecessary complexity in the preparation of financial statements.
• In the light of the accounting scandals the costs of rules-based standards outweigh their benefits.
• Rules-based standards create a scope for providing a roadmap to avoidance of the accounting objectives inherent in the standards. As a result it creates a leeway to engineer the way around the intent of the standards. This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events.
• Rules can become useless and, worse yet, dysfunctional when the economic environment changes or as managers create innovative transactions around them.
• The big firms have concocted all kinds of slippery methods that enable companies to comply with the exact letter of the rules while still managing to mislead investors.
• The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives
• Critics of rules-based standards argue that such standards encourage firms to structure transactions in such a way that they comply with a strict reading of the rules while avoiding the intent of such rules.
• Aggressive reporting is more likely in rules-based settings.

MANIPULATION OF ACCOUNTING RULES OR PRINCIPLES
It is very difficult to stop abusing of creative accounting practices by the concerned authorities to ensure the authenticity of accounting information because day by day business transactions are becoming complex and there are leeways in the accounting principles or rules. Reasons of Manipulating Principles or Rules:
Shah et al. (2011) summarize why the managers are motivated for fixing financial statements by manipulating principles or rules for either managing position or profits. Following are important concerns for managers:

- **To Meet Internal Targets:** The managers want to cook the books for meeting internal targets set by higher management with respect to sales, profitability and share prices.

- **To Meet External Expectations:** Company has to face many expectations from its stakeholders. The Employees and customers want long term survival of the company for their interests. Suppliers want assurance about the payment and long term relationships with the company. Company also wants to meet analyst’s forecasts and dividend payout pattern.

- **Provide Income Smoothing:** Companies want to show steady income stream to impress the investors and to keep the share prices stable. Advocates of this approach favor it on account of measure against the 'short-termism' of evaluating an investment on the basis of the immediate yields. It also avoids raising expectations too high to be met by the management.

- **Window Dressing for an IPO or a Loan:** The window dressing can be done before corporate events like IPO, acquisition or before taking a loan.

- **Taxation:** The creative accounting may also be a result of desire for some tax benefit especially when taxable income is measured through accounting numbers.

- **Change in Management:** There is another important tendency of new managers to show losses due to poor management of old management by some provisions.

**HARMONIZATION OF PRINCIPLES & RULES**

Accounting standards are different in country to country because accounting standards are customized to fit the business and tax system of a particular country. It is known that U.S. GAAP is rules-based and IFRS is principles-based. For a consistent system of accounting it is necessary to harmonize these two standards.

**Convergence between IFRSs and US GAAP:**

According to IFRS Foundation, the IASB and the US Financial Accounting Standards Board (FASB) have been working together since 2002 to achieve convergence of IFRSs and US generally accepted accounting principles (GAAP). A common set of high quality global standards remains a priority of both the IASB and the FASB.

In September 2002 the IASB and the FASB agreed to work together, in consultation with other national and regional bodies, to remove the differences between international standards and US GAAP. This decision was embodied in a Memorandum of Understanding (MoU) between the boards known as the Norwalk Agreement. In 2008 the two boards issued an
update to the MoU, which identified a series of priorities and milestones, emphasizing the goal of joint projects to produce common, principle-based standards.

In April 2012 the IASB and FASB published a joint progress report in which they describe the progress made on financial instruments, including a joint expected loss impairment ('provisioning') approach and a more converged approach to classification and measurement.

In February 2013 the IASB and FASB published a high-level update on the status and timeline of the remaining convergence projects.

QUALITATIVE ISSUES
TO PREVENT MANIPULATION OF PRINCIPLES OR RULES

Besides enacting suitable rules or principles it should be keep in mind that ethics and culture is important to ensure relevancy, reliability, and consistency of accounting information and the responsibility and accountability of the stakeholders relating to accounting.

Ethics: Ethics is moral principles that govern a person’s behavior or the conducting of an activity. Accounting ethics is primarily a field of applied ethics, the study of moral values and judgments as they apply to accountancy. It is an example of professional ethics.

If the Financial Statements Preparers (i.e., Accountants) are ethically motivated person then they will emphasize on “Substance over Form” which is very essential to avoid scandal in accounting. In accounting, Substance over form is the concept that the information shown in the financial statements and accompanying disclosures of a business should reflect the underlying realities of accounting transactions, rather than the legal form in which they appear.

In case of ethics of the Auditors, it can be said that if the auditors are given the right amount of remuneration for their service they provide as a public accountant then it is presumable that they will emphasize on the objectives of financial statements rather emphasizing on tricking to wink at the substance over form. Here the main issue is that the environment should be non vulnerable so that no one tends to lean in adopting unfair means.

Another important thing is that accounting ethical issues should not only be confined to accountant and auditors but also it should be extended to those who are responsible to regulate. So the regulator or the government should monitor the accountability of the auditing firms whether they are performing their duty sincerely or not. In case of missing accountability of the auditor, the government should enact perfect law which will discourage auditors to depend on illegal auditing.

To infuse the stakeholders of accounting with the professional ethics the following suggestion by Loeb (1988) can be useful:
Relate accounting education to moral issues.
Recognize issues in accounting that have ethical implications.
Develop "a sense of moral obligation" or responsibility.
Develop the abilities needed to deal with ethical conflicts or dilemmas.
Learn to deal with the uncertainties of the accounting profession.
"Set the stage for" a change in ethical behavior.
Appreciate and understand the history and composition of all aspects of accounting ethics and their relationship to the general field of ethics.

Culture: Culture is a set of beliefs, customs, practices and behavior that exists within a population. To avoid manipulation of accounting rules or principles by the accountants or the auditors there should be socio-cultural environment where no one will adopt unfair means in accounting. To do this it is significant that all the stakeholders who are directly or indirectly related to using accounting information should be concern about their responsibility and accountability. In this way, there will be a culture of desired accounting practices.

TRADE-OFF BETWEEN PRINCIPLES-BASED OR RULES-BASED STANDARDS

- Both principles-based and rules-based accounting standards have limitations. So we have to ensure a trade-off between Principles-Based and Rules-Based accounting standard. In order to do this accounting principles (or conceptual framework) should be used as constitution which should be strictly followed in order to ensure relevancy, reliability and consistency of accounting information. On the other hand accounting rules (or detail guidelines) can be used as assisting tools to the financial statements preparers (e.g., accountant) but these rules should be changed time to time in order to ensure that no one is manipulating these rules to fulfill their ill motive.
- There could be a public platform where expert opinion from experienced accountants, managements, auditors as well as the regulator would be considered to establish accounting rules or describe existing accounting practices that are suitable to comply with the accounting principles. In this case it should be kept in mind that detail rules does not appear as overload and to remove the overload the previous rules of a particular matter should be dismissed.
- Rules from public forum should be replaced by the concerned regulators to comply with the objectives of preparing the financial statements and there should be a clear guidance from the regulators that every stakeholders relating to accounting will be accountable if they derail from the objectives of financial statements.
CONCLUSION

It is known that nothing is absolute. Both principles-based and rules-based standards have some limitations. So it is necessary to trade-off between these two approaches to produce acceptable accounting treatment. It is also necessary to ensure that there is a strong audit committee and extensive scrutiny by the regulator and government to prevent aggressive reporting. The most important thing is that all related parties of accounting should practice professional ethics by which it can be expected reliable accounting information. Both the IASB and IFRS should continue their mutual effort to ensure the reliability, consistency, comparability of accounting information.

REFERENCES


**ABBREVIATIONS USED**

CFO = Chief Financial Officer

CPA = Certified Public Accountant

FASB = Financial Accounting Standard Board

GAAP = Generally Accepted Accounting Principles

IASB = International Accounting Standard Board

IFRS = International Financial Reporting Standard

IPO = Initial Public Offerings

MoU = Memorandum of Understanding

SEC = Securities and Exchange Commission