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Exploiting the Gaps in GAAP: A Look at the Principles Versus Rules Debate

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CLAREMONT MCKENNA COLLEGE

**EXPLOITING THE GAPS IN GAAP:
A LOOK AT THE PRINCIPLES VERSUS RULES DEBATE**

SUBMITTED TO

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AND

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BY

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FOR

SENIOR THESIS

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Introduction

American accounting standards had long been considered the benchmark to which most other international standard-setting bodies compared. This influence in the international accounting realm largely rested on the strength of the United States capital markets, among other things. Yet, lately many academics, professionals, and auditors have voiced various concerns about US accounting standards and their ability to generate reliable financial information. Still, the predominant sentiment in America was to just continue 'business as usual'. Faced with the challenges of an ever evolving and increasingly globalized business world, US accounting standard-setters considered the value of international standard adoption. Though they had engaged in conversations with international standard-setters and initiated several joint ventures¹, their efforts have been largely unsuccessful. Unbeknownst to the accounting community, one of the largest ever corporate insolvencies was looming on the horizon. Enron, a Texas-based energy, commodities, and services company, had been named 'America's Most Innovative Company' by *Fortune Magazine* for six consecutive years (Q&A: The Enron case, 2006). By late 2001, it was revealed that Enron's success had been largely sustained by taking advantage of creative accounting techniques. On December 2nd, 2001,

¹ Accounting for revenue recognition is an example of one of these efforts. In the United States, for example, there are over one hundred different ways to account for revenue. In countries abroad that elect to use IFRS, the international set of standards, revenue recognition is largely determined by one basic standard, IAS 18. As such, the American and international standard-setting bodies have attempted to work together towards convergence with the intention of increasing global comparability (Howard, n.d.).

Enron filed for Chapter 11 Bankruptcy Protection under Title 11 of the United States Bankruptcy Code (Oppel and Sorkin, 2001). Once the dust had settled, questions immediately began to surface. People wondered how Enron had been able to exploit loopholes and perpetuate this fraudulent accounting treatment for so long. It was evident that Enron had gone to great lengths to conceal the truth regarding its earnings, “and its cooperative auditors failed to insist that it follow the *rules* on related party transactions” (Bratton, 2003, p. 1042). So were Enron’s opportunistic managers to blame? Or was it the company’s ‘independent’ auditors, Arthur Anderson? Still many pointed to the progressively more complex accounting standards. The answers to these questions will be more fully explored later, but one could argue that, to some extent, all three, the management, auditors, and standards, played a role in propagating the fraud.

Enron and Arthur Anderson, one of the largest accounting firms in the world², were both dissolved within a matter of years. Enron ended its bankruptcy in 2004 and sold its final remaining entity in September 2006 (The rise and fall of Enron: A brief history, 2006). Doomed to a similar fate, Arthur Anderson voluntarily forfeited its licenses to practice accountancy in the United States in 2002 following a guilty verdict in relation to the firm’s handling of the Enron audit (Beltran, Gering, and Martin, 2002). The more long-lasting impact, however, was the calling-to-question of the once seemingly infallible US accounting standards. Often crises can serve as an impetus for institutional change. Investors, both domestic and

² Arthur Anderson was, at the time, one of the ‘Big 5’ accounting firms. The other four were, and are still to this day: Deloitte Touche Tohmatsu, Ernst & Young, PricewaterhouseCoopers, and KPMG.

international, began to lose confidence in the merit of US financial reporting. More explicitly, one author cites the American accounting scandals of 2001-2002 as one of the most essential drivers responsible for igniting “accounting standard harmonization³ by breaking a deadlock between the US accounting authorities and the IASB⁴” (Eaton, 2005, p. 1).

Many, at both the individual and institutional levels, began to question why, during a historically deregulatory period in the United States, accounting standards were becoming more and more complex (Sawabe, 2005). Though perhaps an over-attribution, many point to the highly technical yet flawed accounting rules as the main culprit in the Enron scandal. They argue that had the accounting rules been better, the fraud may have been avoided. Regardless of the validity of this argument, US standards had grown increasingly precise over time, characterized by detailed guidance and numerous exemptions. Many felt that this precision not only invited, but encouraged, opportunistic interpretation of accounting standards by corporate management (Agoglia, Douppnik, and Tsakumis, 2011). More and more, managers began developing a ‘Where does it say I can’t do this?’ mentality. Creative managers gradually started to “exploit the gaps in GAAP⁵” (Anson, 2002). That is, these managers structured transactions in such a way that they would technically be in compliance with the standard but would ultimately fail to communicate the

³ Accounting standard harmonization refers to the reduction in variation between the different bodies of standards used internationally.

⁴ International Accounting Standards Board (IASB): board responsible for issuing international accounting standards in over 115 countries, including all companies listed in Europe.

⁵ Generally Accepted Accounting Principles

economic reality, a practice known as regulatory arbitrage⁶. During the 'Dot-Com Bubble'⁷, the number of inappropriately structured transactions grew and eventually led to massive overstatements and subsequent restatements. The Government Accountability Office (GAO)⁸ issued a report in October 2002 noting that restatements by public companies increased from ninety-two in 1997 to two hundred twenty-five in 2001. Between January 1997 and June 2002, eight hundred forty-five companies had announced restatements, nearly ten percent of all those publicly traded. So again, why this move towards more rules in accounting standards?

This movement was driven primarily by two factors: the United States legal environment and demand from managers and auditors, a related but separate topic. There seems to be a propensity towards rules in the US legal system. The existence of rules allows for actors to hide behind so-called 'bright lines'. A bright-line rule is objective and clearly defined, allowing for little or no interpretation. In the United States' health care system, for example, practitioners are forced to issue numerous, and often unnecessary, tests in order to avoid potential malpractice lawsuits. In a similar vein, managers and auditors prefer rules because they can point to adherence of a certain rule in court as a means to absolve themselves of any

⁶ Regulatory arbitrage: "the practice of structuring an inappropriate transaction so it stays within the bounds set by a rule" (Bratton, 2003).

⁷ The Dot-Com Bubble refers to a period from approximately 1997-2000 during which speculative investors experienced huge stock price increases in the internet sector before they peaked in March, 2000, followed by a quick, steep decline in price (Here's why the Dot Com bubble began and why it popped, 2010).

⁸ The GAO is "an independent, nonpartisan agency that works for Congress, supporting them in meeting their constitutional responsibilities and ensuring the accountability of the federal government" (Herrick and Barrionuevo, 2002).

wrongdoing. Of course, this propensity towards rules often does not align with investors' desires for timely, relevant, and reliable information, much like unnecessary tests do not align with patients' desires for a reasonable hospital bill.

In response to the accounting scandals of 2001-2002, Congress was forced to step in and act. On July 26, 2002, after a 99-0 vote in the Senate and a 423-3 vote in the House, Congress presented the Sarbanes-Oxley Act of 2002 to President George W. Bush. On July 30, the president signed the Act into law, marking the most significant piece of securities legislation since the Great Depression. Some of the key provisions of the Act include: the establishment of a five-member accounting oversight board, increased ban on consulting activities for audit clients, audit partner rotation⁹, required communication with the audit committee, and a study on the value of principles-based accounting. Pursuant to Section 108(d) of the Act, the Securities and Exchange Commission (SEC)¹⁰ conducted this study and issued a report on their findings. There was a growing concern about accounting standards in the United States, and many pointed to the high level of rules and guidance as the primary issue with GAAP. Assessing the value of a more 'principles-oriented' approach over the more 'rules-oriented' approach, the SEC reported that the US standard-setting body would be "moving forward with a more principles-based approach...as a means of increasing the quality of financial reporting and restoring

⁹ Audit partners responsible for reviewing the audit of a particular client must be rotated every five consecutive years (The Sarbanes-Oxley Act of 2002, n.d.)

¹⁰ Securities and Exchange Commission (SEC): In response to the Great Depression, Congress enacted into law the Securities Exchange Act of 1934, creating the SEC. The SEC was tasked, among other duties, with helping to develop and standardize the financial information presented to stockholders and investors. The SEC, a federal agency, delegates its role of developing standards to the independent, private FASB.

trust in the current financial reporting system” (Bailey and Sawers, 2012, p. 41). That said, the SEC study does acknowledge that no regime can preclude fraud entirely. Malevolent actors will always find ways in which to behave dishonestly, no matter how well the rule or standard be been constructed. Still, the SEC study argues for a reconceptualization of US accounting standards, one in which managers and auditors are held accountable primarily to the principles behind the standards and secondarily to the detailed implementation guidance, or rules.

The remainder of this paper will be organized as follows. The next section provides a description of the accounting conceptual framework and briefly describes the parties involved in the standard-setting process. The following two sections further discuss the United States legal environment and how incentives of managers and auditors are not always aligned with those of investors. The next section briefly describes both the rules-oriented and principles-oriented approach to accounting standard-setting, discusses in more detail the findings of the SEC study (mentioned above), and investigates the ‘rules versus principles’ debate. The following section examines the effects of standard type on litigation incidences and outcomes, and the final section includes concluding remarks regarding standard implementation.

Conceptual Framework, the FASB, and GAAP

In order to engage in an informed ‘rules versus principles’ debate, one must first obtain a fundamental understanding of the conceptual framework. The framework establishes the underlying principles behind accounting standards. The Financial Accounting Standards Board (FASB) is a full-time, well-paid, independent standard-setting body, responsible for generating the conceptual framework and defining its objectives. Shortly after the board was created in 1973, they developed a theoretical structure that would help define and resolve financial reporting issues. The FASB, comprised of seven members from the accounting profession, the corporate world, and academia, is supported by the SEC to work towards its mission to “establish and improve standards and financial reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information” (Facts about FASB, n.d.). Armed with the support of the SEC, the FASB established the primary objective of the conceptual framework: decision usefulness for financial statement users. Financial statement preparers should strive to create relevant and reliable information, which ultimately enhances comparability between firms. Each of these supporting pieces contributes to decision usefulness in a unique way, and these characteristics can even be in conflict, at times.

The level of relevance a piece of financial information is said to possess is determined by the extent to which it makes a difference in the decision formulating process. Relevance itself is determined by three main components: predictive value,

confirmatory value, and materiality. The first component, predictive value, measures how valuable a piece of information is in the prediction formulation process. Predictive value enhances investors' ability to forecast the future amount and timing of cash that will be received and paid by a company. Since financial information is reported after the fact, the next component, confirmatory value, confirms the extent to which past predictions were correct. Materiality, the final and arguably most important component of relevance, describes information that, if incorrect or omitted entirely, would influence investors' decisions. For example, recording the sale of an iPhone case twice (also known as double-booking) would not likely have a material impact on an investor's decision whereas recording the sale of an iPhone twice would likely materially impact that decision. Though this is a simple, straight-forward example, it helps illustrate the importance of materiality.

Another facet of decision usefulness is reliability. The concept of reliability asserts that the accounting numbers and descriptions match economic reality. Similar to relevance, reliability emphasizes the importance of faithfully represented information. That is, financial information should reflect the economic substance of a transaction. The primary characteristics that increase reliability are: completeness, neutrality, and absence of error. Completeness assumes that no information has been withheld from investors and all material information has been disclosed. Neutrality refers to the desirability for unbiased information. The final aspect, absence of error, does not imply total freedom from error, but rather a reasonable assurance that the information has been presented faithfully. Since

financial statement users do not have the time or adequate resources to evaluate the factuality of content, they are largely forced to depend on the reliability assumption.

If relevance and reliability are said to be in the same family, then comparability and consistency are in the rival family. An important aspect of decision usefulness revolves around investors' ability to compare financial information, both between firms and industries and over time. Comparability is achieved when firms account for similar transactions uniformly in financial reporting (Sawabe, 2005). Consistency asserts that transactions will be accounted for uniformly over time. That is, once a certain accounting treatment is adopted, it will be followed consistently between accounting periods, and if a change were to occur, full disclosure as to why must be stated. Between the two sets of concepts, comparability and consistency and relevance and reliability, an inherent trade-off exists. Tessema asserts, "In the US the call for comparability has, amongst other things, led to what may be called an excessive overregulation" (Tessema, 2012, p. 5). Still, many have called for an even greater emphasis on comparability because, as the standards exist currently, a single economic phenomenon can be faithfully represented in multiple ways. As a result, accounting standards are surrounded by a cloud of public skepticism (Tessema, 2012). Deciding which way to tip the scale regarding this inherent trade-off is no trivial task. Even within similar industries, organizations are very complex and their operations may differ substantially. By placing more emphasis on providing information that reliably depicts the economic reality of each individual organization, comparability must suffer at the hands of relevance.

This trade-off is of particular interest to the FASB. As the body responsible for setting United States Generally Accepted Accounting Principles (US GAAP), the FASB is tasked with the difficult challenge of creating and implementing a generally accepted and universally practiced set of accounting standards. Founded in 1887, the American Institute of Certified Public Accountants (AICPA) is the national professional organization of practicing CPAs, acting as a key contributor to the development of GAAP¹¹. However, before the formation of the Securities and Exchange Act of 1934, there was no universal body of accounting standards in the United States. At the request of the SEC, the AICPA appointed the Committee on Accounting Procedure (CAP) in 1939. Between their inception and 1959, the CAP issued fifty-one Accounting Research Bulletins that dealt with a variety of accounting problems. Serving in a largely reactive capacity, though, the CAP failed to establish a structured body of accounting principles. In response, the AICPA created the Accounting Principles Board (APB) in 1959. The APB issued 31 APB Opinions between 1959 and 1973, but, again, the APB ultimately failed to develop an overall conceptual framework that could assist in the resolution of problems as they surfaced. The FASB, created in 1973, is the body currently responsible for setting accounting standards in the United States. US GAAP is their response to the difficult task of creating a unified set of accounting standards that are not only based on a structured body of principles, but can also adapt to the ever-changing business environment.

¹¹ Mission and History. (n.d.) *AICPA*. Retrieved from AICPA.org

The objective of US GAAP, as stated by the FASB, is the development of “high-quality accounting standards that *serve the public interest* by providing information that is useful in making investment decisions” (Facts about FASB, n.d.). In other words, financial reports produced under the guidelines of US GAAP should provide decision useful information about the reporting entity to current and prospective equity investors, lenders, and creditors. The FASB relies on two basic premises that are vital to achieving this objective: (1) GAAP should consider the entire investing community, not just the accounting profession and (2) it should operate transparently through a ‘due process’ system, allowing input from all interested parties (Kieso, Weygandt, and Warfield, 2012). Though not all steps will always be necessary, the FASB outlines the seven procedures used for developing accounting standards. The due process system is as follows:

1. Board receives recommendations for possible projects/reconsiderations of existing standards
2. FASB chairman decides which projects to move forward with by adding them to the technical agenda
3. Public meeting(s) held to deliberate various issues verified/identified by staff
4. Board issues Exposure Draft (or Discussion Paper to help develop Exposure Draft, if necessary)
5. Board holds public roundtable meetings on Exposure Draft, if necessary
6. Staff analyzes comment letters/roundtable discussions and updates Exposure Draft, if necessary

7. Board issues Accounting Standards Update explaining any changes or additions to US GAAP

If US GAAP functions correctly, from the conceptual framework to the due process system, all interested parties should be able to make well-informed decisions regarding the provision of resources to an entity. Often times, however, US GAAP fails to provide financial statement users with decision useful information. No set of accounting standards can completely preclude fraud, but even when managers and auditors act within the limits of US GAAP, information is not always relevant and reliable. Just as an inherent trade-off between relevance and comparability exists in the conceptual framework, there is a similar challenge in standard setting. This challenge is commonly referred to as the *principles-based* versus *rules-based* debate. As you may have noticed to this point, however, I have been referring to standards as either *principles-oriented* or *rules-oriented*. This difference is subtle, but arguably quite important. To refer to a standard as 'rules-based', one must imply that principles take a back seat to rules. However, all standards are firmly rooted in the conceptual framework. Surely, some standards have a large quantity of rules and exceptions (accounting for earnings per share guidance extends over one hundred fifty pages), but the issues these standards address are highly technical and require at least some level of guidance. Rather than referring to these standards as rules-based, they will be referred to as rules-oriented. Standards that are generally devoid of these bright-line rules and exceptions, traditionally referred to as principles-based, will be referred to as principles-oriented. By focusing on orientation, as

opposed to categorizing standards as either principles- or rules-based, the conversation is not limited to deciding between two broad, exclusive categories.

Though this discussion will be investigated more exhaustively throughout, at an elementary level, some standards allow for things such as estimates and valuations, thus placing a greater value on relevance. Standards regarding lease and stock option accounting, for example, include numerous guidelines that are intended to increase comparability. Unfortunately, managers sometimes elude these guidelines and misrepresent economic reality, all the while within the technical limits of US GAAP. Comparability is crucial to creating decision useful information, but rules-oriented standards do not always lead to the achievement of this goal. There is a perceived grave concern that if managers are given more discretion over accounting treatments, they will take advantage of this freedom and the financial statements will lose a large sense of comparability in exchange for increased relevance. However, rules do not stop malevolent managers and auditors from acting fraudulently, and they often disallow benevolent managers from reporting the most relevant information to the investing public. Numerous forces are at work here, and I will argue that the potential loss of comparability is justified by the increase in relevance, and, in turn, increase in reliability.

US Legal Environment: Deregulation, the FASB, and the Big 5

During the 1970s, the US Congress and other federal regulatory agencies began to loosen pricing, entry, and exit policies in the transportation, financial, energy, and communications industries. Commenting on deregulation, Winston (1998) remarked, “I believe that the academic community has reached a consensus that [its] net benefits to consumers are substantial” (Winston, 1998, p. 90). Regulated markets, he argues, tend to result in economic inefficiencies. Conversely, deregulated markets are largely free from pricing, entry, and exit restrictions, allowing firms to be competitive and maximize potential efficiency. During this period of sweeping deregulation in the United States, however, the accounting industry seemed to move in the opposite direction. In highly litigious environments, such as the one found in the United States, standard setters grow reluctant to accept standards that permit multiple interpretations and applications of the same principle (Tessema, 2012), and thus they include more rules, regulations, and guidance. Considering the legal environment and pressures from special interests and auditors could explain the FASBs tendency to introduce increasingly complex and detailed accounting standards (Sawabe, 2005) by the end of the 1990s. Any existence of discretion in accounting decisions exposes managers, as well as auditors, to a higher risk of litigation. Even if managers act in good faith and exhibit the required professional judgment, enforcing agencies can still allege violation of a principles-oriented standard. As such, auditors prefer more rules-oriented

standards because they use readily-determinable values, such as acquisition cost and market price, which can serve as a layer of protection for their firm from future legal action.

Auditors are also greatly influenced by accounting conservatism, or the propensity to require a high degree of verification before making a *legal* claim to any profit. For example, probable losses and most expenses are recognized immediately, whereas revenue is almost never recognized until the earnings process is complete. The idea here is that it is easier to explain an understatement than an overstatement, especially in the court of law. Though accounting conservatism is conducive to the United States legal environment and may serve firms and auditors well, it does not provide the most faithfully represented picture to investors.

Even after the Private Securities Litigation Reform Act of 1995 (PSLRA)¹² adjusted the United States legal system to make accounting firms less susceptible to lawsuits by private plaintiffs (Bratton, 2003), more detailed guidance continued to emerge in accounting standards. In the years leading up to the Enron scandal, accounting firms realized that the risk of lawsuits based on alleged negligence and inappropriate application of GAAP was high (Benston, Bromwich, and Wagenhofer, 2006). As a result, the accounting industry was incentivized to ask for more rules in hope of avoiding these costly lawsuits. Donelson, McInnis, and Mergenthaler called

¹² Rule 10b-5 of the PSLRA asserts that a complaint must allege five sufficient facts to survive a motion to dismiss including: (1) a misstatement or omission of (2) a material fact (3) made with intent (4) that the plaintiff justifiably relied on (5) causing injury in connection with the purchase or sale of securities (Skinner, 1994).

these assumptions into question during their 2012 study titled “Rules-Based Accounting Standards and Litigation”. Somewhat intuitively, they found that standards with more clear guidance and rules do, in fact, result in less litigation. Interesting though, they did not find a statistically significant difference in lawsuit outcomes¹³. So, is the FASB acting as an independent standard-setting body, or is GAAP “as much a product of political action as it is of careful logic or empirical findings” (Kieso, Weygandt, and Warfield, 2012)?

Managers and auditors prefer rules, but should investors?

As Sawabe (2005) pointed out, accounting standards with more detailed guidance are systematically favored by Anglo-Saxon standard setters. By the year 2000, non-audit services¹⁴ had grown to represent over fifty percent of revenue for the Big 5 accounting firms. To find an example of compromised independence, one need not look any further than the Enron case. Enron solidified its relationship with Arthur Anderson in 1993 when Anderson not only provided internal audit services to the firm, but also sold the firm its compliance system¹⁵ (Herrick and Barrionuevo,

¹³ That is, the type of standard (‘rules-based’ or ‘principles-based’) and presence of detailed guidance did not have an effect on the outcome of individual lawsuits. These results, and the associated study, will be discussed in more detail later.

¹⁴ Pursuant to Section 201 of the Act, non-audit services include, but are not limited to: bookkeeping of the audit client, information system design and implementation, valuation services, actuarial services, internal audit services, human resources, investment advisory, and legal and expert services.

¹⁵ Compliance systems help firms learn about their GAAP compliance responsibilities and ensure employee understanding of these responsibilities. They help “manage risks associated with changing product and service offerings and new legislation enacted to address developments in the marketplace” (Compliance Examination Manual, n.d.).

2001). In general, auditors are tasked with the often difficult undertaking of both keeping their clients happy and performing their duty to the investing public. At times, this can prove to be detrimental to the auditor-client relationship. With Enron, Arthur Anderson faced this inherent tension in addition to compromised independence: “The audit firms’ incentive to take positions adverse to their clients’ with respect to aggressive treatments diminished correspondingly...An auditor is hardly likely to question the effectiveness of a compliance system sold by his or her firm” (Bratton, 2003, p. 1030). Arthur Anderson’s long-standing relationship with Enron certainly affected their judgment regarding Enron’s financial position and internal controls. Arthur Anderson was motivated to maintain their very profitable relationship with Enron, and in doing so they ignored economic reality and approved highly questionable transactions, ultimately cumulating in one of the world’s largest ever accounting frauds.

Throughout the 1990s, the accounting profession lobbied with frequency and success. Bratton (2003) alleged that the profession had “become famously aggressive protecting its own interests and those of its clients in the corridors of power in Washington” (Bratton, 2003, p. 1033). Special interest groups fighting for the accounting profession shot down reform to accounting for stock options¹⁶ and consulting fees. Many raised concern, including Arthur Levitt in his book *Take on the Street*, about what was happening on Wall Street and in Corporate America regarding these issues, especially consulting fees. As mentioned above, by the year

¹⁶ A stock option gives an individual an opportunity, but not an obligation, to purchase a share of a company’s stock at a predetermined price at a point or during a specified period in the future.

2000, non-audit services had reached over fifty percent of total revenue for the Big 5. A major component of those services was consulting fees. Often times, accounting firms provided their clients with both consultation and audit services. Consulting fee reform called for a separation of these duties. As it stood, accounting firms were essentially auditing the work of their own employees. Excluding the possibility of collusion, audit engagement teams were less likely to doubt work provided by their own firm. With this framework in place, “no institutional mechanism ensures that the public interest trumps the interests of audit firms and their clients in GAAP’s promulgation” (Bratton, 2003, p. 1038). Thus, accounting firms were more incentivized to keep customers happy while generating consulting fees than to demand that the economic reality of the client has been faithfully presented to the investing public, creditors, and banks. If managers and auditors disagreed on an issue, auditors’ only recourse was to recommend a different accounting treatment, but they often did so at the risk of losing both the audit and consulting fees.

Standard creation and reform gives rise to another complicated issue. Throughout the SEC’s existence, the commission has delegated the task of accounting standard creation to private, independently funded groups¹⁷. Unfortunately, though, at times the “agency delegation model” (Bratton, 2003) has failed and these groups have fallen prey to special interests. For example, stock option accounting reform was first tried by the APB in 1972, and again by the FASB during the 1990s. In 1972, many were calling for the immediate expensing of the granting of stock options to employees and managers. With the issuance of APB

¹⁷ These groups are as follows: CAP (1939-1959), APB (1959-1973), and FASB (1973-Present).

Opinion 25, the APB allowed managers to continue not expensing stock options if the option price was below market value on the grant date (Miller and Bahnson, 2002). Rather than providing clarification on a highly debated issue, the APB created a bright-line rule that essentially allowed and arguably encouraged managers to pay employees, and themselves, large amounts of compensation without recording any expenses. This was a big win for industry, and when these unreported expenses reached large proportions of the income statement in the early 1990s, the FASB was forced to return to the issue. The FASB proposed that an expense should be recorded equal to the value of the stock options on grant date. To the huge relief of managers, the FASB compromised with SFAS 123, merely suggesting the reporting of an expense on the income statement but permitting the reporting in a pro forma footnote (Miller and Bahnson, 2002). The agency delegation model “works well only so long as the agency successfully resists capture by the interests of the actors it regulates” (Bratton, 2003, p. 1032). The FASB has shown time and time again that it will succumb to political pressure. These pressures often come from industry, but they can also come from the SEC and Congress. SFAS 123 was largely influenced by the preparer constituency, which exploded and called upon members of Congress to threaten the board with extinction (Miller and Bahnson, 2002). The FASB can exist only so long as Congress recognizes it as the standard-setting body. As such, they have very little room to disregard the will of the Congress, even if they do not agree with the Congress’s position. After the fall of Arthur Anderson, the fear grew that if any of the remaining four firms were able to gain a direct or indirect influence over the FASB, they would

stop at nothing to protect their rents from further restriction. As accounting standards stand, Bratton believes they “will continue to be the best choice in a second-best world so long as they constrain managers and auditors most of the time [from opportunistic behavior]” (Bratton, 2003, p. 1037).

The Rules vs. Principles Debate: An Introduction

As mentioned above, the primary objective of the FASB is to “establish and improve standards and financial reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information” (Facts about FASB, n.d.). Basing these standards on the conceptual framework, the FASB hopes that financial statement preparers will adhere to the concepts of relevance, reliability, and comparability in the promotion of decision usefulness. Once a standard has been conceptualized and created, the next step is implementation of said standard. There are two dominant thoughts on the process of implementation. One school of thought argues that standards should be very heavily based on the principles inherent in the conceptual framework. The other school of thought believes that standards should include detailed guidance, or rules, regarding how that standard should be implemented. As a result of this difference, the ‘rules vs. principles’ debate were born. Think of the following example for a moment: curfew for a high school student. The parents of the high school student have two options. The first is that they may set their child’s curfew for, say, 1:00 AM. This would be

characterized as a bright-line rule, one that allows the child to return home at 12:59 AM unscathed. However, if the child was to return home at 1:01 AM, he or she could, and likely would, face the wrath of mom and dad, and rightfully so. Conversely, the parents of the high school student could tell their child to return home at a 'reasonable time'. In this situation, it is largely up to the child to determine what was meant by reasonable. It may be the case that child decides that a reasonable time is 12:00 AM. It may also be the case, and most parents would likely agree with this sentiment, that the child would interpret a reasonable time as 3:00 AM. As such, it seems that rules are a better solution to this dilemma.

The solution may not be so evident, though. There are two primary forces at play here. The first is that the child may very well return home at 12:00 AM. This makes both the child and the parent happy. The second force is that if the child was to return home at 3:00 AM, it is likely that his or her parents will be very upset and he or she will face a consequence. As such, he or she will be much less likely to return home late again. Initially, there may be some costs involved on both sides in trying to understand each other's desires and arrive on an agreed time. Ultimately, though, the parents and child will arrive upon a reasonable time to return home, and both will be happier.

Although this example is relatively elementary, it illustrates some of the key arguments posed by proponents of principles-oriented and rules-oriented approaches to standard-setting. All standards are based on the conceptual framework, and are thus grounded in principles. They earn their distinction based on the presence of rules, exceptions, and guidance. The *GAAP hierarchy* is a

descriptive term explaining preferences either toward overarching concepts and principles or toward specific, context-bound rules. Many are concerned that GAAP has grown to represent the latter, a guidance heavy, rules-oriented set of standards that place greater emphasis on the form of certain rules than the substance of the principles (Benston, Bromwich, and Wagenhofer, 2006; Bailey and Sawers, 2012; Tessema, 2012). Yet, others are not so convinced. Following the fallout of the Enron scandal, both the SEC and FASB issued reports on the value of 'principles-based' standards. They concluded that there was indeed a problem with accounting standards in the United States, but they were hesitant to describe GAAP as solely 'rules-based'. Whichever characterization of US GAAP is true, Bailey and Sawers point to prior research suggesting that "managers and accounting professionals use the latitude in accounting standards, either judgment in applying principles or structuring transactions around rigid rules, to manage earnings and support aggressive financial reporting" (Bailey and Sawers, 2012, p. 27). There seems to have been a shift in the application of accounting standards from attempting to accurately communicate the economic reality of a transaction to merely being in compliance with standards. In other words, whether the standard being applied is more rules-oriented or more principles-oriented in nature, the evidence seems to suggest that managers are focusing more on presenting the firm in the most positive light that GAAP will allow rather than attempting to faithfully represent the firm (Hackenbrack and Nelson, 1996; Salterio and Koonce, 1997; Nelson and Kinney, 1997; Hoffman and Patton, 2002).

Rules-Oriented Standards: Defined

Before the conversation can continue, it is important to define the terms being discussed. US GAAP has been characterized as a highly influential and regarded system of *rules*. Though all may not agree with this characterization entirely, the FASB did seem to have been trending towards standards with an extremely high level of specification around the turn of the century. Eaton remarked, “keeping the account preparers inside the rules meant anticipating where they would find loopholes and closing them off” (Eaton, 2005, p. 7). Historically, the FASB had done quite a good job policing these loopholes and issuing more detailed guidance on how to deal with them as they emerged. Unfortunately, it only takes one major slip up to derail the entire effort. The focus on and call for more principles-oriented standards really emerged when it was revealed in 2001 that Enron had taken advantage of a complex, highly detailed accounting standard. Though both Enron and Arthur Anderson alike ignored many of the principles behind the standard, GAAP still absorbed a large hit, even causing Congress, the SEC, and the FASB to question its value.

Yet, rules are not fundamentally bad or even ineffective. One of the many advantages of more rules-oriented accounting standards is that they provide clear guidance to both preparers and auditors. This guidance can significantly reduce managers’ ability to influence or manipulate relevant accounting numbers (Tessema, 2012). The SEC states that “Inherent in a rules-based approach is the intent to minimize the judgmental component of accounting practice through the

establishment of finely articulated rules that attempt to foresee all possible application situations” (SEC, 2003). With the exception of a few very large, publicized frauds, these more rules-oriented standards have functioned seemingly well in the United States. Rules and detailed guidance give standards-setters the ability to accurately and effectively communicate their requirements and intentions to managers. The clear expression of these expectations can help to reduce the imprecision and uncertainty that allow managers to potentially report aggressively (Nobes, 2005; Schipper, 2003). In fact, Katherine Schipper, a member of the FASB when they published their commentary on principles-based accounting standards, remarked that rules give financial statements increased comparability and provide auditors and regulators with increased ability to verify those financial statements (Schipper, 2003). Though some have argued that rules simply create a safe harbor under which auditors can hide from litigation, rules do give auditors the ability to consistently apply standards amongst clients, between auditing firms, and across the United States. Rules-oriented standards certainly are not perfect, but as Bratton (2003) suggested, they may be better than the alternative.

Principles-Oriented Standards: Defined

Principles-oriented standards rest primarily on the concept of ‘substance over form’. In other words, this principle ensures that the financial statements present a relevant and reliable representation of actual transactions and events. Application of the ‘substance over form’ concept involves the question of whether the firm has presented its financial statements such that they represent economic

reality (substance), or that they merely present compliance with the letter of the law (form). Bratton (2003) characterizes principles-oriented standards as more broadly stated, often excluding particular application guidance on their face. Though some standards are objectively rules-oriented¹⁸, even principles-oriented standards can work like rules when applied literally. As firms grow increasingly innovative, complex, and specialized, so do their transactions. As such, the particulars of these transactions may differ considerably or slightly, yet rules enforce common treatment. Though Schipper (2003) was hesitant to describe US GAAP as rules-oriented, she did admit that a more principles-based system is desirable because such a system permits the appropriate exercise of professional judgment to auditors.

Principles-oriented standards intentionally avoid exhaustive specifications, relying on the conceptual framework and the principles included therein. GAAP was created with the intent to convey four basic principles: relevance, consistency, verifiability, and full disclosure. Though there is a strong theoretical argument for principles-oriented accounting standards (Sawabe, 2005; Eaton, 2005; Tessema, 2012), it is not quite so simple in practice. There exists an inherent tension in the current conceptual framework. For example, the framework requires verifiable information but also requires that information to be relevant. At times, the most relevant numbers may not be verifiable, and vice versa. For example, GAAP permits

¹⁸ The most classic example is the standards regarding lease accounting. These standards contain many bright-line rules, including cut-off points and yes-or-no distinctions, which decide how certain leases should be accounted for. Lease accounting will be discussed in further detail later.

the use of fair value accounting¹⁹. Fair values are not always readily determinable, especially in highly specialized industries, but they are often more relevant than more objective measures of value, like historical cost. In creating standards that permit the use of fair value accounting, the FASB sometimes places a higher value on relevance than verifiability since managers likely know most about their firm's transactions and economic reality. In a theoretical world in which managers are completely benevolent, a solely principles-oriented set of accounting standards would function better. However, this does not describe the world GAAP functions in. Financial statement users would likely require increased disclosures outlining the accounting treatment decision-making process, leading to potential inefficiencies.

Now that both rules-oriented standards and principles-oriented standards have been defined, the 'accounting standards continuum' can be introduced. On one end of the continuum are more broadly-defined principles. On the other end of the continuum are more highly-detailed rules. As discussed above, detailed rules can increase verifiability and consistency by providing managers and auditors with guidance. Alternatively, broad principles can increase relevance by giving managers the ability to more faithfully represent their firm's financial position. Around the turn of the century, the pendulum had swung towards the rules-oriented end of the spectrum. Since the Enron scandal, subsequent fallout, and implementation of Sarbanes-Oxley, the pendulum began swinging back in the direction of principles, though still on the rules side of the continuum. There are many opinions about the

¹⁹ Under US GAAP (FAS 157), fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale (Summary of Statement No. 157).

optimal position for US GAAP on the accounting standards continuum. Unfortunately, there is no consensus about that position between managers, accountants, and the regulatory bodies. The SEC explored the debate about the optimal position in a report issued in 2003, suggesting a potential combination of rules-based and principles-based standards. Though the study has prompted numerous discussions between the FASB and the IASB, nothing tangible has resulted thus far.

SEC Study on the Adoption of a Principles-Based Accounting System

Pursuant to Section 108(d) of the Sarbanes-Oxley Act, the SEC conducted a study on the adoption of a principles-based accounting system during 2003. As suggested above, many groups and individuals, from investors to creditors to managers to even the CEO of Arthur Anderson, pointed to the failure of US GAAP in preventing the accounting scandals of 2001-2002. The SEC examined whether US GAAP is, in fact, a rules-based set of accounting standards, as well as the potential value of a more principles-based set of standards. The Sarbanes-Oxley Act, the most significant piece of securities legislation since the creation of the SEC, called upon the SEC to “conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system” (SEC, 2003). The growing concern in the United States was that US GAAP had become too oriented around bright-line tests, which allowed managers to misuse the current standards by complying with

the letter of the law but not the spirit of standard. There was also a large concern about the growing level of exceptions to the underlying principles of certain standards, permitting firms to treat similar transactions and events with similar economic substance differently. Another concern revolved around the increasing need and demand for detailed implementation guidance, creating complexity and ambiguity about the application of US GAAP.

Bearing in mind these concerns, the Sarbanes-Oxley Act mandated that the SEC explore the following four areas:

(i) the extent to which principles-based accounting and financial reporting exists in the United States; (ii) the length of time required for change from a rules-based to a principles-based financial reporting system; (iii) the feasibility of and proposed methods by which a principles-based system may be implemented; and (iv) a thorough economic analysis of the implementation of a principles-based system (SEC, 2003).

As a result, the SEC determined that the current system of financial reporting and corporate governance were in need of improvement. The Sarbanes-Oxley Act may be viewed as a legislative attempt “to better align the incentives of management, auditors and other professionals with those of investors” (SEC, 2003). This study evaluated the ways in which the SEC and the FASB may achieve the goals set forth by the Act. At the conclusion of the report, the SEC laid out the following six action items: in the short-term, conduct a comprehensive review of current standards to identify and address those that are rules-oriented, establish one standard setter, begin working towards accounting standard convergence with the IASB, and issue

more principles-oriented standards, and in the long-term, conduct conceptual framework improvement projects and redefine the GAAP hierarchy.

At some point, or more likely over a period of time, the system of checks and balances critical to investor confidence in financial reporting began to deteriorate. Though the SEC acknowledged that no standard-setting regime can completely preclude fraud, they did suggest an optimal standard setting process. In studying the current condition of US GAAP, they concluded that “imperfections exist when standards are established on either a rules-based or a principles-only basis” (SEC, 2003). ‘Principles-only’ standards present a problem because they provide managers and auditors with very little guidance for exercising professional judgment. This lack of guidance can lead to a significant loss of comparability because the potential exists for similar transactions to be accounted for differently. Conversely, ‘rules-based’ standards can provide not only a vehicle but also a defense for evading the intent of the standard. Rules-based standards can provide managers with a roadmap to circumvent accounting standards and result in financial reports that are not representationally faithful. As such, the SEC was hesitant to characterize US GAAP as entirely ‘rules-based’, but they did offer a solution to improve the current standard-setting process.

These more principles-based, or objective-oriented standards, should have the following characteristics: established from an improved conceptual framework, have a clearly articulated objective, provide enough detail and structure to be applied consistently, have minimal exceptions, and avoid the use of bright-lines, or percentage tests, that give preparers the ability to structure transactions to achieve

technical compliance while evading intent (SEC, 2003). The exact methods of implementation the SEC suggested will be discussed at greater length below, but the underlying message was holding managers and auditors accountable for reporting the *substance* of transactions. As a result, financial reports would be seen as an act of communication rather than merely an act of compliance. The SEC concluded that though the costs of this transition would likely be high and the magnitude of the benefits difficult to quantify, “the benefits of adopting objectives-oriented...standards in the US justify the costs” (SEC, 2003). Though the FASB has voiced continued support of adoption, little headway has actually been made. For example, after placing leasing accounting reform on their agendas in 2006, the FASB and IASB began working jointly in 2009. On May 16, 2013, the FASB issued a revision to the 2010 proposed Accounting Standard Update, Leases. The FASB and IASB are currently considering all feedback and re-deliberating the significant issues raised, hoping to issue another exposure draft during the first quarter 2014. Though they are close to reaching a consensus, the FASB and IASB have yet to issue an update to leasing standards after eight years. Nobes (2005) attributes this inability to produce an update to the FASB's proclivity for arbitrary rules and IASB's proclivity for vagueness. The report suggested a redefinition of the conceptual framework as a long-term goal, but in order for these two standard-setting bodies to produce anything meaningful in a timely manner, they must better align at the conceptual level. Though the SEC report did offer valuable insights and proposed interesting suggestions, the ideas have not yet materialized.

Regulatory Arbitrage: The Issues with Rules-Oriented Standards

The findings and subsequent suggestions presented in the SEC report are based on the notion that rules-oriented standards can be problematic, and that more principles-oriented standards may offer a solution to those problems. One of the primary driving forces behind the rules-oriented issue is regulatory arbitrage. In other words, rules-oriented standards allow for the dominance of legal form over economic substance. Eaton (2005) points out the existence of a “perception among many US accountants that bright line rules invite deceptive accounting” (Eaton, 2005, p. 9). That is not to say that regulatory arbitrage is encouraged by accountants. Rather, the potential to engineer transactions exists and is more likely to occur under a rules-oriented standard-setting regime.

But why is this transaction engineering such an issue? In the discussion of the conceptual framework and its connection to rules-oriented standards, comparability is cited as one of the most crucial features of these types of standards. Further, relevance often suffers in order to increase comparability between firms and consistency over time. However, when regulatory arbitrage occurs, it can result in ‘surface comparability’ (Alexander and Jermakowicz, 2006). Surface comparability arises when “the application of specific rules may require economically different situations to be accounted for identically” (Alexander and Jermakowicz, 2006). Tessema (2012) defines this phenomenon as pseudo-comparability. In these cases, rules prevent managers from faithfully representing

their financial position, giving rise to the necessity for exceptions. As transactions grown increasingly complex, standard setters are often faced with a decision to add exceptions and guidance, which may further increase complexity, or leave the standard as is, which can restrict managers from faithfully representing their firms.

Another, more dangerous, type of surface comparability appears as a result of real earnings management, or “a change in the structure of transactions or events in order to avoid the consequences specified by an accounting standard” (Tessema, 2012). Financial statements are intended to reflect the economic reality of the firms they represent. They should reflect if firms have highly cyclical income or if firms own or lease their assets. Tessema argues tighter, rules-oriented accounting standards do increase real earnings management. With leases, for example, managers often construct lease contracts in such a way that the terms fall just within the bright-line thresholds set forth by the standard. As a result, firms are able to materially change the presentation of their financial statements. Benston, Bromwich, and Wagenhofer (2006) attributed a large part of the Enron scandal to this phenomenon. Though rules-oriented standards are based off the conceptual framework, they foster an environment of compliance: “Enron could claim and Anderson concurred that calling the simultaneous purchase of two very different assets was a ‘business’ because there was no rule to say that it wasn’t” (Benston, Bromwich, and Wagenhofer, 2006, p. 177). However, the rules themselves are not the only things to blame. Yes, US GAAP did technically permit Enron to act as they did, but the individuals at Enron actively chose to take advantage of these loopholes. In times of crisis, there is a propensity to point fingers at the accounting industry

and the accounting standards, but lack of integrity by management is an often overlooked driver in many cases. As standards continue to include a growing number of rules and exceptions, it becomes more and more conceivable that these rules could contradict principles, but there must also be individuals to take advantage of these contradictions.

In summary, the potential for contradictions to exist causes uneasiness and lack of trust in the more rules-oriented US GAAP (Bailey and Sawers, 2012). Managers may be incentivized to structure transactions around the rules, leading to potential manipulation of financial information. In turn, investors may be sufficiently incentivized to more thoroughly examine financial reporting decisions by management (Miller and Bahnson, 2002). This lack of trust in financial reporting does not serve the investing public and causes unnecessary uncertainty. Investors are left to wonder whether relevant facts have been misreported or unreported. This can lead to an overall higher cost of capital²⁰, retarding economic growth and inhibiting stability (Miller and Bahnson, 2002).

Principles-Oriented Standards: A potential solution?

Though there were likely many driving forces, the US accounting scandals of 2001-2002 provided a spark that energized the conversation about a more principles-oriented US GAAP. As Sawabe (2005) suggested, “The principles-based

²⁰ From an investor’s perspective, cost of capital refers to the accepted level of return required by shareholders to invest.

approach to standard setting was a *conscious strategy* to counter creative accounting” (Sawabe, 2005). As a growing number of rules were issued, managers responded by continually redesigning their creative accounting instruments. As new loopholes were discovered, new rules would be issued, further complicating the standard implementation process. With the following quote, explains why firms, auditors, and regulators desire rules:

“Companies want detailed guidance because those details eliminate uncertainties about how transactions should be structured. Auditors want specificity because those specific requirements limit the number of difficult disputes with clients and may provide a defense in litigation. Securities regulators want detailed guidance because those details are thought to be easier to enforce” (Sawabe, 2005).

As you may recall, the primary objective of the conceptual framework is to provide decision useful information to financial statement users. Though Sawabe highlights valid concerns held by the three groups, he fails to acknowledge the most important group, investors. Standard implementation has somewhat become an act of compliance rather than an act of communication, and investors have suffered as a result (SEC, 2003).

Some managers are currently taking advantage of the loopholes in US GAAP, and their auditors are permitting these actions because they are technically within the limits of the standards. This is as much an issue of integrity as it is an issue with the set of standards. Managers are making the choice to exploit the gaps in GAAP, and auditors are allowing it to happen. It seems that a more principles-oriented

GAAP would give managers the ability to distort economic reality even further, but as many have suggested, this shift could alternatively realign manager incentives. Currently, managers are practically encouraged to take advantage of accounting loopholes because there are between little and no consequences. They get away with things like off-balance sheet financing every year, and GAAP helps justify these actions. With a more principles-oriented set of standards, managers would have to justify their accounting treatments based on economic reality, no longer able to hide behind rules and exceptions. This does not necessarily address issues of professional integrity, but it could realign management and auditor incentives. Over time, managers might rethink their implementation of US GAAP as an act of communication rather than an act of compliance.

Though she acknowledges the merits of more principles-oriented standards, Schipper (2003) ultimately rejects the notion of 'principles-only' standards, citing the resulting potential reduction in comparability, consistency, and regulatory enforcement as her primary reasoning. Similarly, the FASB issued a Proposal in October 2002: *Principles-Based Approach to US Standard Setting* (MacDonald, 2002). MacDonald explained that much of the complexity and detail found in accounting standards had been demand-driven. She claimed that much of the detailed guidance was introduced as a result of requests from managers and auditors. Likewise, MacDonald concluded the FASB Proposal by rejecting 'principles-only' standards. She feared that standards without detailed rules "could lead to situations in which professional judgments, made in good faith, result in different interpretations for similar transactions or events, raising concerns about comparability" (MacDonald,

2002). Though this is a valid concern, as discussed above, surface comparability can often be the result of rules. As Alexander and Jermakowicz (2006) reminded, managers likely have the deepest knowledge and understanding of their firm's economic reality and, thus, how it should be accounted for. However, managers sometimes ignore economic reality and choose the most beneficial accounting treatment because they are protected by bright-line rules. Principles-oriented standards could actually curtail this behavior because managers would be required to provide their rationale for given treatments to their auditors, and their auditors would have to assess these explanations on their value rather than their adherence to a rule. Especially in the post-Enron world, auditors are even more incentivized to prevent fraud and avoid the fate of Arthur Anderson at all cost.

Detailed rules can often stifle a standards ability to allow for faithful representation, discrediting professional judgment. Perhaps worse, though, the existence of detailed rules can provide a roadmap for 'economic discretion' (Sawabe, 2005). Rules-orientated standards are intended to curtail accounting discretions. Accounting discretion refers "to those [discretions] relating to accounting treatments of recognition and measurement" (Sawabe, 2005). Though these treatments can have a potential material impact on the financial statements, they do not affect the economic substance of the firm. That is, cash inflows and outflows are not altered by accounting discretion. Economic discretion, alternatively, can have an impact on the economic substance of the firm. Sawabe argues that "Economic discretions are usually more costly than accounting discretions because they affect cash flows *for the sake* of accounting numbers" (Sawabe, 2005). Though detailed

rules can prevent numerous accounting treatments of similar transactions and events, they also provide a safe harbor for managers and auditors to hide behind. Managers are protected by adhering to the precise guidelines provided in US GAAP. In addition, auditors are less inclined to question their clients' accounting numbers because they met each line-item on a, sometimes arbitrary, checklist. This can be especially harmful and costly because questionable transactions are often accepted when they fall within the detailed guidelines of certain standards. Investors, in turn, are potentially given a false sense of confidence in the reliability and comparability of financial statements.

With a move away from more rules-oriented standards back to their principle-oriented roots, many have suggested that more relevant and reliable information would result (Miller and Bahnson, 2002; Nobes, 2005; Agoglia, Douppnik, and Tsakumis, 2011). Though managers and auditors prefer rules, "the less precise the standard, the more concerned preparers are about second-guessing and possible costs imposed through regulation and litigation" (Agoglia, Douppnik, and Tsakumis, 2011, p. 749). With less detailed guidance, managers are highly incentivized to represent the underlying economics of their firm as accurately as possible. One thing to consider, though, is managers' compensation is usually tied, in some capacity, to firm performance. Managers may have stock options that are tied to the stock price or bonuses dependent on earnings per share targets, so there may be an incentive to inflate the firm's earnings. In a 2013 study, Ali and Zhang looked at the relationship between CEO tenure and earnings management. They found that CEOs are generally highly incentivized to avoid misstating earnings in order to

prevent loss of reputation (Ali and Zhang, 2013). Experience has shown that this is not true of all managers, especially those in their first or final years, but a more principles-oriented US GAAP could incentivize managers to faithfully represent their firms. If managers make a concerted effort to fairly portray economic reality and they have sufficient evidence to support their choices, “then they will be better able to defend themselves when second-guessed by external parties” (Agoglia, Douppnik, and Tsakumis, 2011, p. 752). The result of this more principles-oriented world should be better information for financial statement users. If managers and auditors are wary of potential litigation and reputation loss, they should be incentivized to represent their firms faithfully, and have strong evidence to support why they chose a particular accounting treatment. Earnings management exists in part because US GAAP permits it and in part because managers are opportunistic. A potential solution is to alter US GAAP, removing the rules and exceptions that allow managers to point at the standards for protection. There will still be opportunistic managers, but they will lack the bright-line rules to hide behind.

When a regulatory body takes down stop lights and road blocks (or bright-lines), the assumption is that chaos will necessarily ensue. Perhaps this example can shine some light onto the debate. Public officials in London were experiencing a crisis. Faced with a growing population, one of the busiest intersections in the city was getting busier. The intersection had essentially halted to a stop, creating traffic for miles in all directions. They brought in civil engineers from across the world, and no one could seem to find a solution to the congestion. They tinkered with the duration of wait times, the number of stop lights, and they even tried instituting a

fee to use the road, but nothing worked. Eventually, one individual proposed a seemingly insane solution: simply remove all of the stop lights and signs. The idea was shot down initially by many, objecting that no one would ever stop. However, the idea was eventually approved, and within months, the traffic had not only improved, but was practically free flowing. Though there were obviously many forces at work here, one of the most important was that of incentives. At the most basic level, drivers were incentivized not to crash into each other. They quickly learned how to not only avoid collisions, but also how to communicate and move freely amongst one another.

There is no evidence to suggest that removing all rules from accounting standards would lead to a similar outcome as the one above, and that claim is not being made. Rather, the example provides an interesting insight into the economic concept of incentives. People, and firms, tend to act in their own self-interest. A sometimes overlooked aspect of the 'principles-rules' debate is that there are costs, in fact very large ones, related to managers reporting fraudulent accounting numbers and auditors approving those numbers. Lawsuits and, more importantly, reputations are at stake. Similar to the stoplight example, Christopher Nobes, a Professor at the University of Reading, England, proposed a solution to improve standard clarity: a reduction in rules. His study was based on the notion that the "use of a more appropriate principle would reduce the need for arbitrary and detailed rules" (Nobes, 2005, p. 32). Rather than increasing guidance to account for the ever evolving business world, he suggested retooling standards to more closely reflect principles from the conceptual framework. The argument is that the need for

guidance develops, in part, from demand by managers and auditors, but also from ‘rouge principles’ (Nobes, 2005) that may not align directly with the conceptual framework. He provides numerous examples that could improve from a reduction in rules including: lease accounting, financial assets, subsidiaries, and equity accounting. These examples tangibly highlight some of the problems associated with more rules-oriented standards, and will be discussed in more detail shortly. The bottom line is that a reduction in rules can be associated with “increased clarity, decreased complexity, and *decreased motivation for the structuring of transactions*” (Nobes, 2005, p. 27), placing a greater emphasis on economic substance than legal form.

Example: Lease Accounting – Form over substance?

Though there are countless examples of rules-oriented standards that fail to accomplish their goal of faithful representation, none is more visibly guilty than accounting for leases. According to a study published by the Equipment Leasing and Finance Foundation²¹, the global equipment finance market returned pre-Great Recession levels by 2012, an estimated \$725 billion business. Many different types of equipment are being leased, from helicopters to bulldozers to computers to airliners. The players involved in these transactions are lessees and lessors. The lessee negotiates the right to use specific property for a specified amount of time, while the lessor owns the property in question. In return for the use, the lessee makes rental payments to the lessor over the agreed upon time of the lease. Though

²¹ The Equipment Leasing and Finance Foundation is an independent, not-for-profit foundation that studies markets, trends, and operations relating to the equipment finance industry.

this may seem relatively straight forward, US GAAP allows for two different categorizations: capital leases and operating leases. An operating lease allows the manager to record the expense related to rent immediately on the firm's income statement. A capital lease, conversely, requires that managers capitalize equipment and record the present value of the total lease payments on their balance sheet. Most managers prefer operating leases because they do not have to record an asset on their books, or the corresponding liability. The incurrence of this additional liability affects certain financial ratios and income in the early years of the lease, among other things. Though managers would almost always prefer operating leases, the FASB recognizes that some transaction should be capitalized, so they developed a set of criteria to determine proper accounting treatment.

The FASB developed four criteria for establishing whether a lease should be capitalized or expensed immediately. The criteria are as follows: the transfer of ownership test, the bargain-purchase option test, the economic life test, and the recovery of investment test (Miller and Bahnson, 2002). The first criterion, the transfer of ownership test, is straight forward and relatively easy to apply. Simply put, if ownership transfers at the completion of the lease, then the lease must be capitalized. The next three criteria, however, are not so easy to test and have created numerous controversies. The second criterion, the bargain-purchase option test, allows the lessee to purchase the asset at the end of the lease at a 'bargain'. This bargain price is determined by estimating the future fair value of the asset, and setting the purchase price at a point well below that estimate. The third criterion, the economic life test, asserts that if the term of the lease is longer than seventy-five

percent of the useful life of the asset, then the asset must be capitalized. Not only can useful life be difficult to determine, managers also have the ability to contrast the lease term to last just under seventy-five percent of the useful life. The final criterion, the recovery of investment test, states that if the present value of the minimum lease payments²² equals or exceeds ninety percent of the value of the asset, then the asset must be capitalized.

As you have likely realized, lease accounting is subject to abuse. One can imagine that managers make concerted efforts to circumvent the intent of US GAAP and expense whenever possible. One could argue that there are certain leases that should be accounted for using the operating method, but almost all leases should be capitalized. Benefits to expensing rather than capitalizing include: materially reducing liabilities that should be included in the financial statements and smoothing of expenses²³. An unintended consequence of the rules-oriented lease accounting standard is the propensity for firms to “beat the lease standard” (Dieter, 1979). Managers can relatively easily achieve their goal of avoiding lease capitalization by creative design, writing, and interpretation of lease agreements. Though it may be intuitive, some of the most common ways in which managers avoid capitalization are as follows: (1) ensure that there is no specified transfer of title, (2) exclude a bargain-purchase option, (3) set the lease term to some duration

²² Three important concepts contribute to determining the present value of minimum lease payments: total minimum lease payments, executory costs, and discount rate. Minimum lease payments include the minimum payments the lessee has agreed to pay to the lessor (including, but not limited to, all rental payments). Executory costs refer to things such as insurance, maintenance, and tax expenses. Once these previous two amounts are summed, they are discounted to present value based on the discount rate, or the rate the lessee would have incurred to borrow the funds necessary to buy the leased asset (Ely, 1995).

²³ Smoothing is a concept that will be more fully explored in the next section.

less than seventy-five percent of the useful life, and (4) arrange for the present value of the minimum lease payments to be less than ninety percent of the value of the asset (Kieso, Weygandt, and Warfield, 2012).

Though many have recommended reform to lease accounting (Dieter, 1979; Nobes, 2005; Agoglia, Doupnik, and Tsakumis, 2011), little has come of these recommendations. As Nobes (2005) suggested, political unpopularity may be the biggest obstacle to reform. Leasing standards predate a clear definition of what constitutes a liability. Issued in December 1985, the FASB defined liabilities in Concept Statement No. 6 as “probable future sacrifices of economic benefits arising from obligations of a particular entity to transfer assets...to other entities”. In other words, a liability arises when one firm is contractually obligated to pay another firm in exchange for a service or product. Nobes (2005) believes that much of the arbitrary detail found in GAAP can be remedied by applying a more appropriate principle. Rather than adjusting the current rules, exceptions, and guidance, he believes standard setters should place a greater focus on reflecting the substance of the standard from the start. As such, “obligation under all noncancelable leases meet the definition of ‘liability’ and should therefore be [capitalized]” (Nobes, 2005, p. 28). As referenced above, lease accounting standards were introduced in January 1977, a full eight years before liabilities were concretely conceptualized. Thinking about these noncancelable leases as liabilities would, in part, solve the problems associated with over-expensing and under-capitalizing leases. A more principles-oriented approach to lease accounting “would not lead to imprecision, lack of verifiability, or lack of comparability. All noncancelable leases would be treated in

the same way” (Nobes, 2005, p. 28). Furthermore, Agoglia, Douppnik, and Tsakumis (2011) found that financial statement preparers are less likely to report aggressively when applying a less precise criterion. This is just one example that displays a possible benefit to a reduction in rules-oriented standards. Though lease accounting reform has been on the docket since 2006, and the FASB and IFRS are working together to arrive upon a better accounting standard, the FASB has yet to issue a finalized Accounting Standard Update. A third Exposure Draft will be issued sometime during first quarter 2014, but lease accounting will remain unchanged until at least then. The mere fact that the FASB and the IASB are working towards change suggests that the current standards are in need of improvement.

Accounting Standard Orientation and Litigation

Though some of the concepts discussed in their study²⁴ have been alluded to thus far, University of Texas professors Dain Donelson and John McInnis and University of Iowa professor Richard Mergenthaler examine the competing claims that: (1) rules-oriented standards shield firms from litigation and (2) violations of detailed rules give plaintiffs a ‘roadmap’ to successful litigation. The purpose of their study was to “inform this debate by investigating whether rules-based standards are associated with the incidence and outcome of securities class action litigation” (Donelson, McInnis, and Mergenthaler, 2012, p. 1247). They characterized the two

²⁴ *Rules-Based Accounting Standards and Litigation*

prevalent, competing theories about the relationship between rules-oriented standards and litigation: the 'protection' theory and the 'roadmap' theory. The protection theory asserts that rules-oriented standards lead to lower incidents of lawsuits and decrease the likelihood of unfavorable suit outcomes. This theory contends with the notion that "the specificity of rules-based standards provides plaintiffs with a clear path to successful litigation" (Donelson, McInnis, and Mergenthaler, 2012, p. 1248). The protection theory gives defendants two lines of defense. First, if firms do not admit to an accounting misstatement, then it is very difficult for plaintiffs to uncover if firms have violated any standards and are guilty of wrongdoing. They are shielded by a 'safe harbor', protected by the fact that there is not always access to transparent information. Second, if firms do admit an accounting misstatement, "Managers violating rules-based standards can argue that [it] was an innocent mistake caused by the complexities of GAAP" (Donelson, McInnis, and Mergenthaler, 2012, p. 1248). In essence, firms can hide under the bright-lines of accounting rules, or they can admit wrongdoing and then blame the highly detailed bright-lines for making GAAP too complex, causing an innocent misstatement.

The roadmap theory, conversely, asserts that rules-oriented standards actually lead to higher incidents of lawsuits and increase the likelihood of unfavorable suit outcomes. The argument behind the protection theory is that intent is very difficult to prove. If there is no misstatement, then the plaintiff has to prove both that a transaction or event was accounted for incorrectly, and that the treatment was intentionally malevolent. The roadmap theory argues that "the detail

and objectivity of rules-based standards help to establish intent, as plaintiffs can argue that it is implausible that executives would unintentionally violate the *clear guidance* provide by a rules-based standard” (Donelson, McInnis, and Mergenthaler, 2012, p. 1254).

To test the various relationships between standard type and litigation, the authors looked at lawsuits citing specific accounting standards from 1996-2005, many years before and after the Enron accounting scandal. Interestingly enough, they found that neither the protection theory nor the roadmap theory held true in full. Though there was a correlation between standard type and litigation incidence, the type of standard had no statistically significant effect on litigation outcomes (Donelson, McInnis, and Mergenthaler, 2012). Regarding cases *without* a restatement, they concluded that plaintiffs are less likely to allege violations of more rules-oriented standards. Regarding cases *with* a restatement, incidence of litigation was less across the board, suggesting credence towards the safe harbor assumption. In summary, the authors stated that “the protection theory predicts that plaintiffs will tend to allege standards that are more principles-based due to the safe harbor protection provided by rules-based standards *when firms follow rules*, as well as plaintiffs’ ability to ‘second-guess’ accounting decisions under principles-based standards” (Donelson, McInnis, and Mergenthaler, 2012, p. 1273). As such, they assert that a shift towards a more principles-oriented set of standards would weaken the, currently strong, safe harbor protection, providing plaintiffs with “a wider menu of potential ‘judgment-based’ allegations in cases not involving admitted restatements” (Donelson, McInnis, and Mergenthaler, 2012, p. 1273).

Conclusion: Are filling the gaps in GAAP possible?

Though there is still some debate about the value of adopting a more principles-oriented US GAAP, the overwhelming sentiment in the academic community is that the United States' set of accounting standards have swung too far towards the rules-oriented side of the continuum. Though there are certainly transactions and events that require some level of guidance, the FASB, facing pressure politically and from industry, has created a highly rules-oriented US GAAP over time. There is currently a propensity towards more and more guidance and bright-line rules. Among the primary justifications for this tendency is that rules-oriented standards lead to more comparability, which ultimately improves the quality of financial information. However, as discussed above, often these standards lead to nothing more than surface comparability. Surface comparability can be extremely problematic because it creates the perception that firm's financial statements are comparable. In reality, though, firms are structuring transactions around guidance and bright-line rules, causing them to alter their actual operations, not just their accounting numbers.

A more principles-oriented US GAAP would give managers the ability to more faithfully represent their firm's economic reality. Allowing managers to prepare relevant, faithfully represented financial statements should lead to more decision useful information. However, there are numerous factors that must be taken into account when considering a transition away from rules-oriented standards. First,

there are many logistical hurdles that need to be jumped. As Samaila (2012) pointed out, any transition would likely be very highly capital intensive. Implementation challenges would range anywhere from staff training to US GAAP redesign or replacement to consultancy fees regarding proper reclassifications. In addition to restructuring costs, there would likely be increased legal fees. Though Donelson, McInnis, and Mergenthaler (2012) found that standard type does not affect litigation outcomes, they did suggest that principles-oriented standards do lead to higher incidences of litigation. The increased number of lawsuits could tangibly affect firms financially, as often times firms reach settlements before suits ever make it court. Another concern raised by Schipper (2003) revolved around the resources of the SEC. She did not believe the SEC had adequate resources to devote to answering registrant questions about acceptable interpretations or engage in detailed discussions about registrant choices, which would surely increase with a move away from rules-oriented standards.

These challenges, though difficult to quantify financially, can be reasonably estimated and accounted for from a cost-benefit analysis standpoint. The larger challenge, then, revolves around the issue of integrity. As discussed in numerous sections, managers find creative ways to circumvent the current highly rules-oriented standards, and auditors do not always do enough to counteract this creativity. Still, it would be imprudent to suggest that principles-oriented standards would prevent managers from participating in opportunistic behavior altogether. However, though this solution would require more auditor liability and is not necessarily a short-term answer, Smith suggested that “Educators need to

increasingly emphasize two values that have long been the mainstay of accountants' reputation: integrity and professional skepticism" (Smith, 2003, p. 48). Aggressive, unethical behavior by top management at Enron largely crippled the company's ability to function and prosper, and ineffective auditors perpetuated their behavior. Managers can be incentivized to act in the interest of their firm or their own self-interest. As such, ethics in accounting are essential to producing financial statements that encourage public confidence. Neither rules nor principles can completely preclude malevolent managers from reporting fraudulently, but the interplay between managers and auditors can lead to more decision useful information.

With bright-line rules and guidance lifted and a move back towards the principles of a standard, managers can attempt to present the most relevant information possible. Though managers best know about the transactions and events of their firm, they are also optimistic about their firm's future. It is here where auditors, bound by a strong code of professional ethics and skepticism, must hold managers accountable. Rather than relying on a detailed set of rules, managers and auditors should be allowed to arrive upon faithfully represented numbers. In a rules-oriented world, managers are able to hide behind bright-lines in accounting standards, and auditors are not incentivized enough to challenge their clients who are technically in compliance. In a principles-oriented world, conversely, managers' optimism and auditors' conservatism are allowed to interact and produce more relevant, and hopefully, more reliable information. Stripped of the ability to point to mere compliance with a rules-oriented standard, managers would need sound

reasoning for a certain accounting treatment, and auditors would be responsible for approving that reasoning.

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