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Principles verses Rules-Based Accounting Standards' Application in Fiji: An Overview of the Literature

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Abstract

The emerging economies differ significantly in terms of the size, structure, capabilities of the accounting institutes and regulatory bodies. The difference in the organizational culture in the emerging economies to that of a developed economy raises several concerns about the application of the principle - based accounting standards fostered by International Accounting Standards Board (IASB). Culturally, the professional accountants in Fiji prefer to adhere to rule as opposed to principle - based standards that requires exercise of significant judgment. Thus, the purpose of this paper is to elaborate on the strength and weaknesses of the rule and principle - based accounting standards and will specifically focus on the applicability of each type of the standards in the context of a less developed country – Fiji.

Keywords: Rule – based accounting, Principle – based accounting, IASB, Applicability, Standard.

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Introduction

Rule versus principle - based accounting standards debate was brought up by the accounting scandals such as Enron, WorldCom and so forth. The accounting practice in the past or traditionally varied across the globe. The underlying reason for the variation was the application of the rules or principles - based accounting standards across countries. Principles - based accounting is used as a conceptual basis for accountants (Sargeant, n.d.). The word principle is a general statement, with widespread support that acts as a guide to action. These principles are intended to capture the underlying economic reality of transactions. In contrast, rule - based accounting standards provides a set of rules with detailed guidance, clarifications, and precise answers to questions.

The emerging economies differ significantly in terms of the size, structure, capabilities of the accounting institutes and regulatory bodies. The difference in the organizational culture in the emerging economies to that of a developed economy raises several concerns about the application of the principle - based accounting standards fostered by International Accounting Standards Board (IASB).

The emerging economy such as Fiji lacks resources to enforce and train professional accountants to make sound judgment to reflect economic reality. In addition, Fiji is culturally different from developed countries such as USA and Europe, who have greater input in the development of the standards. Culturally, the professional accountants in Fiji prefer to adhere to rule as opposed to principle - based standards that requires exercise of significant judgment. Thus, the purpose of this paper is to elaborate on the strength and weaknesses of the rule and principle - based accounting standards and will specifically focus on the applicability of each type of the standards in the context of a less developed country – Fiji.

Rule versus Principle - Based Accounting Standards

Principle- based accounting standards are standards based on a conceptual framework and require the use of judgment by preparers, auditors, and regulators. The Working Group of the Institute of Chartered Accountants of Scotland's view was that accounting standards should be firmly governed by high - level principles with only the absolute minimum additional guidance required to make the standard operational (ICAS, 2006).

Therefore, the preparers and the auditors would need exercise and defend their judgments. The principle approach relies on professional judgment in applying the principles relevant to the transaction(s) rather than stipulating a set of rules to be followed. These standards focus on the notion of substance over form, where the economic realities are reported in the financial statements.

In contrast, the rule - based accounting standards is defined as a set of rules with detailed guidance and clarifications. The Working Group of the Institute of Chartered Accountants of Scotland's defined a rule as a means of establishing an unambiguous decision - making method (ICAS, 2006, p.4). Rules - based approach attempts to specify actions for each instance, that is, rules with which to comply in specified situations. Both types of the accounting standards have strengths and weaknesses.

Strengths of Principle-Based Accounting Standards

Principle – based accounting standards has the flexibility to deal with new and different situations. The standards are rigid under the rule - based accounting and may not be applicable to new and different situations. Many businesses under ruled - based accounting have limited scope on the applicability of the standards. The principle - based accounting standards has the flexibility to be applied across the national boundaries and across diversities of culture.

Under the principle - based accounting, the standards are flexible to take into consideration the needs of special cases which may not be possible using rule - based standards. The judgments reflect the economic reality that is applicable to particular organization. Furthermore, Doupnik and Richter (2003) argued that principles – based standards provide greater choices in recognition and measurement of various accounting transactions and incorporate uncertainty expressions that requires exercise of accountants' professional judgments

Limitations of Principle-Based Accounting Standards

The most obvious limitation of the principle - based accounting standards is the risk of the litigation. The fundamental concept is that judgment can be demonstrated to be reasonable in light of the facts and circumstances presented at a particular time. The real question is to what extent the judgment made by the preparers of financial reports represents the economic reality. This task becomes more difficult when the business environment includes complex financial transactions. The complexity in the underlying business transaction and lack of rule as preferred under principle - based standards could result in inaccurate judgments to be made. This indeed, increases the risk of litigation. Dickey and Scanlon (2006) explain that the lawsuit culture especially in America may lead to companies facing an increased threat of legal action, in the absence of strict rules. Hence, the litigation issue makes the rules - based system as preferable to principles-based system.

Principle - based accounting standards requires the preparers, and the auditors to exercise significant professional judgment. It raises several questions whether the principles - based accounting standards are providing rooms for earnings management or creative accounting. The manipulation under a principles - based system can occur in the judgment rather than through manipulation of rules. These judgments are supported by the guidance that makes the standard operational. Limited guidance and rules under the principle - based accounting can lead a number of interpretations by the auditors, preparers and the management. Earley (2001) and Vera-Munoz et al. (2001) argued that it will be onerous task to train professional accountants to interpret and apply these standards in a consistent manner given the changes in the business environments and the issue of complex principles - based International Financial Reporting Standards (IFRS)

The exercise of judgment may result in differing practices and outcomes and therefore less comparability between the accounting treatments of different companies.

Comparability is a very important issue for all the stakeholders who may make decisions or evaluate performance based on company results, and use industry averages to evaluate their investments. In addition, comparability is one of the qualitative characteristics of the existing conceptual framework. Lin et al., (2003) and Psaros and Trotman, (2004) raised concern about the consistency with which judgments are made by individual accountants in applying principles - based accounting standards. Bagranoff et al. (1994) argued even if IFRS are adopted in a similar manner across nations, this does not ensure consistent understanding and application of these standards. Chambers and Wolnizer (1991) explained that inconsistency exist because IFRS represent a principal - based regime and allows for significant discretion.

There is difficulty in the enforcement of the principle - based accounting standards. The most obvious reason is that these standards provide insufficient structure as a basis for ensure compliance. Under the principle - based standards, regulators do not give detailed implementation guidance and it is difficult to ensure that standards will be applied in an absolutely consistent manner. Schipper (2003) suggested that both preparers and auditors may find the cost of dealing with enforcement agencies to be much reduced if there is clear and detailed guidance as to what is expected. This may not be achievable under the principle – based accounting standards.

Strengths of Rule-Based Accounting Standards

Rule - based accounting standards are driven by the desire for comparability. Schipper (2003) argued that one alleged benefit of detailed implementation guidance is increased comparability. Rules - based standards provide greater comparability than principle based - accounting standards. The argument is that the preparers and the auditors will adhere to the set of rules and the financial outcome will be comparable. Furthermore, rule - based accounting standards are more authoritative and enforceable. The rule - based standards is easily enforceable by the regulators as the outcome can be consistently measured.

Mostly the preparers, auditors, and regulators prefer rules - based standards because it provides detailed guidance and solution to problems. They use these standards to justify their actions and it reduces the risk of litigation. The requests for greater details in the rules-based standards arise because both preparers and auditors want to minimize the risk of lawsuits. The litigation against audit firms increased in scale the audit firms looked to the standard setters for bright line rules that could support audit opinions (ICAS, 2006). The argument in favor of the rules - based accounting standards is that it is very helpful where the translation is required. The rule - based standards provides comprehensive information on how to deal with issues.

Rules - based standards has been supported on the basis that it will deter creative accounting. The common view is that the preparers and auditors have to follow a detailed set of rules to deal with financial events and there is less or no room to manipulate the figures. Nelson et al. (2002) argued that detailed guidance reduces earnings management.

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Limitations of Rule-Based Accounting Standards

Rules - based standards reduce or eliminate the exercise of professional judgment (ICAS, 2006). This practice will eventually down grade the expertise of the profession as more reliance is made on a set of standards. Whenever the preparers and auditors will face any issue, they will refer to the set of standards for solutions rather than exercising their professional expertise to reflect the true and fair view.

The rules - based standards can never be comprehensive enough to provide answers to each different case. These standards are generally for businesses with similar information and it is applied across industries and countries. There will be certainly special cases and we cannot argue with certainty that rule - based standards will be applicable across industries and countries. This may not lead to true and fair presentation of financial event as more focus will be on the outcome based on a set of rule than on the economic realty.

The critics of rule - based accounting standards argue that it encourages creative accounting. These standards foster creative accounting by diverting judgment from economic reality to the details of application. Rules - based accounting adds unnecessary complexity, encourages financial engineering, and does not necessarily lead to a ‘true and fair view’ or a ‘fair presentation’ (ICAS, 2006). Rules - based standards do not necessarily prevent dishonest practice as the continuous user of the accounting standards are able find means and ways to get around the system. We believe that neither rules- based standards nor principles-based standards can prevent dishonest practice (ICAS, 2006). The United State of America (US) through Generally Accepted Accounting Principles (GAAP) used a rule -based accounting system. The corporate collapse such as Enron, Tyco and many of the other accounting scandals provide an insight into how the rules - based system can facilitate problems and scandals. Dickey and Scanlon, (2006) argued that the general concession being that US rule - based accounting permitted public companies to structure transactions that were essentially engineered to achieve certain accounting and financial reporting results. If we use Enron as an example, the management was able to cover up the losses of underperforming entities, increase the share prices and maximize their remuneration by bending the rules and manipulating earnings to suit their specific needs.

The greater detail in the rules - based standards may cause more complexity as greater amount of rule needs to be translated with correspondingly greater difficulties. These standards often are very detailed and the standards are quite large documents. As a result the users of accounting standards tend to focus on the document rather than the spirit of the standard itself. The emphasis for both preparers and auditors under the rule - based system is not whether the accounts gave a realistic view of entity performance, but whether they complied with list of rules. Rules-based approach makes it difficult for preparers and auditors to comprehend the volume of rules. Benston et al. (2006) suggested the more rules the standards include, the more an override provision is necessary to avoid allowing or even requiring accountants to follow rules by letter but not by intention.

Applicability of Rule and Principle- Based Accounting Standards in Fiji

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Fiji when compared to US, United Kingdom and Australia differ significantly in terms of the size, structure, capabilities of the accounting institutes and regulatory bodies. The Fiji Institute of Accountants (FIA) has adopted the international accounting standards and the IFRSs with some modifications in the previous standards and the introduction of additional accounting standards in the year 2002. Prior to 2002 the accounting standards in Fiji was based on Australian, New Zealand and the IASB standards. Chand and White (2007) argued that the accounting profession in Fiji has been struggling to come to terms with further adoption of IFRSs developed since 2002. The application of IFRS requires the preparers and auditors to exercise significant judgments. The Fiji Institute of Accountants has already fully adopted IFRS for all accounting periods beginning from 1st January 2007.The real concern is whether judgment made in the emerging economies such as Fiji will result in comparable to judgment made under the same scenarios in the developed counties.

The organization culture differs considerably between developed and emerging economies. Manson et al. (1998) argued that evidence shows that organizational culture influences the judgments of professional accountants. The firms in developed economies devote significant amount of resources in developing and training accountants. Even the regulators in developed economies provide resources to issue detailed guidance and training on interpretation and application of the IASs/IFRSs. Lin et al. (2003) suggested that the heavily judgment focused accounting training programmes used by multinational accounting firms to train their professional accountants may further enhance the consensus in judgments. The emerging economies may not have a well-established accounting profession and regulators to interpret and adequately enforce the IFRSs.

Chand et al.(2005) argued that the requirement to exercise professional judgment is of greater concern for emerging economies that may not have qualified and experienced accountants The results of Chand et al.(2005) study in Fiji has shown that differences in judgments between professional accountants could be significant, even within-countries, if standards are new and require complex judgments. Bagranoff et al. (1994) concluded that cross-cultural differences may affect the meaning of, and hence the application of, accounting principles

The recent accounting standards issued by IASB are more complex than earlier standards and requires exercise of judgments to a greater extent. Professional bodies would have to provide training, ethical, and professional guidance to ensure that their members have the ability and the integrity to make such judgments. Chand et al. (2005) suggested that with the appropriate time frame and training the professional accountants in Fiji will be able to apply the IASs/IFRSs in a consistent manner, even if complex judgments are required.

Dickey and Scanlon (2006) highlight these concerns, suggesting that selling principles - based accounting to the business community could be an uphill battle. The only enforcement agency for accounting and financial reporting in Fiji is the Fiji Institute of Accountants. It has limited resources to provide detailed guidance and training on the application of the IFRS and IAS. Additionally, the total membership of less than 600 does not provide the necessary resources to develop relevant training programmes particularly for complex and new IFRSs (Chand et al., 2005). Ball et al.(2003) argued that if countries do not drastically alter their enforcement mechanisms and other political, legal and economic institutions affecting reporting incentives, then comparable financial reporting may not result.

Furthermore, Hopwood (2000) argued that transporting IASB standards to developing countries – which have their own disparate group of external information users that operate within internationally diverse cultural, social, and political environments – should not be expected to have optimum results. The issues of variability in judgments in the emerging economies have completely been overlooked by the IASB and the standard setters of countries that are adopting the IFRSs particularly FIA in Fiji. There may be significant differences in judgments of professional accountants which may impair the comparability of financial information even within the countries. Chand et al. (2005) concluded that if professional accountants in emerging economies are not adequately trained and experienced in applying IFRSs, then standard setters of these countries may consider mandating a set of accounting standards with a greater focus on rules as opposed to principles that require the exercise of professional judgments. The emerging economies may have to consider mandating a set of accounting standards with a greater focus on rules as opposed to principles that require the exercise of professional judgments. The most obvious reason the that the professional accountants in emerging economies are not adequately trained and experienced in applying IFRSs is due to lack of resources. The application of rule - based accounting standard would be easy to apply as detailed set of rules and guidance are already provided.

The principle - based standards of the IASB seems to be inappropriate for the users in Fiji from a cultural perspective. Bagranoff et al. (1994), Holmes and Marsden (1996) and Nobes (1998) considered the influence of culture on the judgments of professional accountants in applying principles - based standards. Fiji is a society dominated by two ethnic groups (Fijians and Indo-Fijians), both of which exhibit Hofstede's (1980) cultural characteristics of uncertainty avoidance and a preference for a society governed by rules as opposed to the expectation that the individual will act appropriately by personal initiative and sound judgment (Chand & White, 2003). In addition, Chand (2005) argued that both groups in Fiji exhibit cultural characteristics of uncertainly avoidance and a preference for a society that adheres to rules as opposed to one that expects the individual to act appropriately by personal initiative and professional judgment. In contrast, Chand and White (2006) found that Fiji's professional accountants have largely succeeded in interpreting and applying the IAS/IFRS in a consistent manner. The finding by Chand and White (2006) is in contrast of the literature in the judgments in emerging economies.

Hofstede (1980) considers power distance as one of the cultural characteristic. In societies such as the U.S. and U.K, small power distance is more applicable. As a result comprehensive accountability is required and where judgments are made, justification may be also required. Fiji is seen as a strong power distance society. In a strong power distance society more effort is placed on the accountability between the agent and the principal rather than the relevance of financial information. Davie (2000) argued that judgment based financial reporting standards introduce ambiguity in the reporting

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processes thus clouding rather than enhancing accountability. Rule - based accounting plays an important role in such societies to improve transparency.

In Fiji, the preparers prefer to use rule - based standards to improve their transparency and the confidence that principals will place in them. However, rule-based standards may reduce the potential relevance of financial reports. One good example of difficulty in applying International Accounting Standards is the IAS 16, Property, Plant and Equipment that requires for all entities to revalue property, plant and equipment. The Fiji Institute of Valuers, with fewer than 70 members does not have the capacity to carry out the informed independent valuations required by IAS 16 (Chand & White, 2007). This requirement will also cost substantially many entities operating in Fiji. Therefore, the users of accounting standards in Fiji experience great difficulty in applying the principle based standards and also for some instances incur severe cost.

Generally, the accountants in Fiji are more comfortable applying a quantitative rule than in exercising professional judgment. Similarly, reluctance has been shown to the adoption of IAS 35, 36 and 37 as these standards particularly require the application of accountants' judgment (Chand & White, 2003). The principle - based standards of IASB are culturally inappropriate in Fiji. Apart from the cultural perspective, the low level of training, experience and inadequate resources vested in accountants of Fiji makes them to rely heavily on the accounting standards as a source of professional guidance.

Conclusion

Benston (2006) suggested that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows. In other words, the application of principles - based accounting standards can faithfully represent the economic substance of the transaction. The fundamental argument in favor of principle - based standards is that it is flexible and will better work in a complex and changing environment. Judgments under the principle - based standards play a key role in reflecting the economic reality. Ijiri (2005) suggested that if the information is useful for investors, it should be provided even if it is subjective leaving more scope and opportunity for deviation from material reality. The drawback of excising judgments is that it creates the opportunity for manipulation but do not necessarily encourage it. There has been widespread criticism of the rule - based standards. The main argument against rule - based standards is that it encourages creative accounting, and creates complexities. These standards do not achieve complete comparability and can't be comprehensive enough to solve all the problems. The complex transaction in different business situation will always require judgment to be exercised.

The major challenge of principle - based accounting standards is that there must be sufficient scope in interpretation of the principles to allow the economic reality to emerge. These standards are applied across national boundaries and across diversities of culture. The current global trend in the development is accounting standards in more towards a principle - based approach. As a result of the corporate collapse of Enron, WorldCom to name a few has led the Financial Accounting Standard Board (FASB) to develop more principle - based standards.

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The IASB intends to achieve international convergence of the accounting standards. The most important aspect of the convergence of accounting standards is the consistent application of accounting standards. The organizations' culture in the emerging economies such as Fiji differs considerably from developed economies. There is concern that professional accountant in Fiji lack training and expertise to make judgment. The reason for such concern is the lack of resources is available for training on interpretation and application of the IFRSs. Furthermore, the professional accountants in Fiji differ culturally to that of US and UK. The cultural characteristics of uncertainty avoidance in Fiji will result society to prefer rule - based accounting system opposed to the principle - based system that requires significant judgment. Furthermore, Fiji is seen as a strong power distance society.

Thus, Chand and White (2003) argued that on the cultural as well as on the economic plane the Franco –German model of financial reporting may be more appropriate to Fiji than that of the IASB. Further to this, the influence of culture and the issue of variability in judgments are ignored by the IASB and the standard-setters of countries that are adopting IAS/IFRS (Chand & White, 2006). The regulators and the standard setters in Fiji have ignored the differences in organizational culture and cultural differences that exist in the country compared to the developed countries. Further research is required on the applicability of IFRS to businesses in Fiji and the extent of consistency in these judgments.

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