Principle versus rule-based standards

A full-page advertisement placed in *The Australian Financial Review* (18 June 2003, p. 13) by PricewaterhouseCoopers advocated the superiority of the principles-based over rules-based accounting standards. The advertisement states Australia is adopting and supporting international accounting standards that are principle-based, with PricewaterhouseCoopers supporting this decision. The advertisement asserts principle-based standards are superior as they

> have a significant impact on eliminating some of the accounting abuses that have helped in America to foster the illusion of growth that has led to investors, companies and the economy paying dearly.
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> Rules-based systems encourage creativity by allowing preparers of reports to stretch the limits of what is permissible under law, even though this may not be ethically or morally acceptable. Rules-based systems lead to an attitude of merely ensuring that technical requirements are met and managers justifying ignoring the substance of a rule by posing the question 'Where in the rules does it say I can't do this?'
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> A principles-base approach requires companies to report and auditors to audit the substance of the transaction, allowing managers and auditors 'to exercise professional judgement to ensure the accounting treatment is fair and reasonable' (p. 13). This allows better decision-making and a more honest and candid description of the health of a business.

A day earlier *The Australian Financial Review* published an article entitled 'Capitalising R & D can cause problems' (Bryan, 2003, p. 30). It warned of technology companies capitalising research and technology costs as an asset in the balance sheet. The article described this practice 'as a burial ground for companies' mistakes' (p. 30). When this technology cannot be sold, huge write-offs result. The above can occur because the definition of an asset is based upon the principle that assets have future economic benefits. The application of this principle involves great subjectivity.

The problem of revenue recognition was discussed in this article. Jan McCahey, PricewaterhouseCoopers financial reporting leader, stated

> One of the problems . . . (is) the lack of detail regarding revenue recognition in the Australian Accounting standards left a lot of grey area for companies to try and interpret (p. 30).

This column has taken the attitude that rules-based or principle-based standards both have their weaknesses. Transactions can be specially designed to circumvent rules, while the subjectivity in interpreting principle-based standards allow preparers of reports options on reporting financial statement items.

References

Bryan Mandy, 2003, 'Capitalising R&D can cause problems', *The Australian Financial Review,* 17 June, p. 30.

PricewaterhouseCoopers, 2003, ‘Principles have no loopholes’, *The Australian Financial Review*, 18 June, p. 13.