

Debate

The Role of Rules and Principles in Accounting

ISSUE: Are principles more important than rules in accounting ethics?

Principles are specific pervasive boundaries for behavior. They are guidelines that can apply to different circumstances. Principles implemented through judgment focus more upon general guidance in making ethical decisions. Rules, however, are much stricter. Rules are prescriptive, easier to enforce, and meant to handle specific situations. Principles are often the basis of rules. Although accounting professions in the United States use Generally Accepted Accounting Principles (GAAP) as a framework for standard financial accounting, U.S. accounting practices are widely thought to be more rules-based than other systems of accounting, such as International Accounting Standards (IAS).

The use of principle-based accounting or rule-based accounting continues to be a significant debate as there are advantages and disadvantages to both approaches to decision making. Under principle-based accounting, professionals would be encouraged to use their own judgment when making decisions. Accountants try to adhere to the spirit of the law rather than the rules of law. Because laws can only cover so many situations—and there are all always exceptions to the rules—using one’s own judgment according to the spirit of the law can help accounting professionals make important judgment calls in ambiguous situations. In fact, recognizing that there cannot possibly be enough rules to account for every accounting situation, the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct adopted several principles, including the responsibility principle, the public interest principle, the integrity principle, the objectivity and independence principle, the due care principle, and the scope and nature of services principle.

The AICPA principles are aspirational and are meant to guide certified public accountants (CPAs) in their professional and ethical responsibilities. According to the code, these principles should act as goals for CPAs in their daily activities. Above all, the principles encourage CPAs to use their best judgment as to deciding upon the most ethical course of action. Because these are principles and not rules, they are not legally enforceable. Rather, they demonstrate the type of conduct expected from CPAs. However, even if they cannot be legally held to the principles, CPAs who abide by them are likely to exercise better ethical decision making skills when faced with complex or ambiguous situations.

It is believed that much corporate malfeasance in accounting likely arose not because accountants broke the rules, but because they bent them. Perhaps the best example is Enron. Enron’s special purpose entities helped it to omit large-scale liabilities from its financial statements and yet still obeyed the accounting rules. While the intention was for unethical purposes as they were meant to deceive investors, legally the accounting maneuvers followed the rules. Former CFO of Enron Andy Fastow claims that he placed rules before principles, looking for ways to bend the rules and seeing ambiguous regulations more as opportunities than risk areas. Conversely, adherence to principles can help individuals recognize ethical issues before they go too far. Additionally, using principles also encourages accounting professionals to assume greater accountability for ensuring the accuracy of financial

information. A greater commitment to organizational values and societal norms reduces the likelihood for ethical rule breaking.

On the other hand, many accountants prefer to have clear rules in place that dictate accounting methods. One of the major reasons rule-based accounting tends to be prevalent in the United States is due to its litigious culture. If accounting professionals make a wrong judgment call, they are likely to be sued by angry investors or even the government. For this reason, they like to have clear standards for what is allowed and what is not allowed. Unlike principles rules are clear and consistent, whereas principles tend to vary upon the situation and even culture. For instance, as there is an attempt to reconcile some of the differences between GAAP and IAS to make them more consistent on an international basis. However, certain principles between the two systems differ, requiring regulators to find ways to get them to coincide. These different perspectives have proven challenging in adopting more international standards for accounting. Supporters of a rule-based system claim that rules provide financial statement users with comparability, allowing them to compare data and gain an understanding of what is acceptable.

Perhaps a more logical approach would be to set rules as a floor and not a ceiling. For example, the government and most states enact ethics laws that are more rule-oriented than based on principles. According to one lawyer there is a gray line among gifts and travel reimbursements for members of Congress. Anything about \$350 should be disclosed. They are also forbidden from accepting gifts or travel reimbursements except for business purposes. However, defining what constitutes a business purpose is not always clear. Some travel or gifts may be intended more as a bribe than a business purpose and yet still fall under the rules of business purpose because it meets the minimum criteria. In this case, using principles would help decision makers understand the spirit of the law. If they follow a principle-based approach, they are not likely to accept something if they believe it is being used to sway their opinion. Principles are helpful for recognizing the gray areas of rules and allowing decision makers to make the more ethical decision.

There are two sides to every issue:

1. An accounting system should be more principle-based to ensure the integrity, accuracy, and transparency of accounting statements that comply with the spirit of the law.
 2. A rule-based accounting system is the best approach for accounting because accountants require clear rules and implementing principles is based too much on judgment.
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