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BRUCE BENNETT, MICHAEL BRADBURY AND
HELEN PRANGNELL

Rules, Principles and Judgments in Accounting Standards

The distinction between rules-based and principles-based standards is not well defined and is subject to a variety of interpretations (SEC, 2003, p. 5). Yet there is a commonly held view that the FASB's standards are rules-based and the IASB's standards are principles-based. This article identifies the basis of this distinction. For research and development, the article compares the FASB standard with two principles-based standards. For each standard we identify and classify rules and judgments, and observe the level of justifications for the rules and assistance to support the judgments. The three standards have rules, are based on principles, and require the exercise of professional judgment; the less conservative standard requires more judgments and, unexpectedly, more rules. The results suggest that the rules-based versus principles-based distinction is not meaningful, except in relative terms. We conclude that a relatively more principles-based standards regime requires professional judgment at both the transaction level (substance over form) and at the financial statement level ('true and fair view' override). Furthermore, it is suggested that any FASB and IASB convergence will require agreement on the weightings given to the qualitative characteristics.

Key words: Accounting; Judgments: conceptual framework; Rules: principles; Standards.

The standard setting process in the U.S. is perceived to have accounting standards that have become overly rules-based. More fundamentally, West (2003, p. 66) suggests that technical accounting rules question the claim that accounting is a professional activity because they 'are suggestive of a procedural activity without an

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Bruce Bennett (bruce.bennett@nzica.com) is General Manager Admissions/Standards and Quality Assurance at the New Zealand Institute of Chartered Accountants. Michael Bradbury is a Professor in the School of Accountancy, Law and Finance, Unitec New Zealand, and a member of the International Financial Reporting Interpretations Committee of the International Accounting Standards Board and the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand. Helen Prangnell is a Senior Lecturer in the School of Accountancy, Law and Finance, Unitec New Zealand, and a member of the Professional Practices Board of the Institute of Chartered Accountants of New Zealand.
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intellectual foundation'. In response to concerns about the rules-based accounting standards, the FASB issued a document outlining the features of a principles-based approach to standard setting (FASB, 2002).[1] The SEC released a staff study that advocates objectives-oriented standard setting that avoids scope exceptions, eschews bright-line tests and reduces excessive detail (SEC, 2003). The FASB responded to the SEC study by reporting a set of action plans that included changing the format and content of standards, setting appropriate implementation guidance and minimizing scope exceptions (FASB, 2004).

Several recent papers address issues related to rules-based versus principles-based standards. For example, Schipper (2003) discusses why U.S. standards are principles-based and why they might be viewed as rules-based. The AAA FASC (2003) analyses the characteristics and costs and benefits of principles-based versus rules-based approaches to standard setting and provides an example of how SFAS 87, *Employers' Accounting for Pensions*, would look if rewritten to stress a principles-based approach. The FASB (2002) uses SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, as an example of a rules-based standard that is over complex, with numerous exceptions. FASB (2002) also shows how SFAS 34, *Capitalization of Interest Cost*, might look like if developed under a principles-based approach. The SEC (2003) uses APB Opinion 16, *Business Combinations*, as an example of a rules-based standard and SFAS 141, *Business Combinations*, as a principles-based approach that also could be described as objectives-oriented. Nobes (2005) argues that rules are based on principles and identifies six accounting standards which he considers contain rules. For each of the six topics he argues that a rule exists because it is based on a poor principle or because it lacks a principle.

The distinction between standards that are rules-based and those that are principles-based is not well defined and is subject to a variety of interpretations (Story and Story, 1998; SEC, 2003, p. 5). Nevertheless, U.S. accounting standards are perceived to be rules-based and International Financial Reporting Standards (IFRS) are, according to the chairman of the International Accounting Standards Board, consistent with underlying principles and require professional judgment (see FASB, 2002, and Schipper, 2003). Hence, based on this perception, the purpose of this study is to examine this issue empirically by providing a comparative analysis of the content and characteristics of a rules-based standard and a principles-based standard.

We contribute to the debate by analysing a purportedly rules-based standard (SFAS 2, *Accounting for Research and Development Costs*) and two purportedly principles-based standards (IAS 9, *Research and Development Costs*, and FRS-13, *Accounting for Research and Development Activities*).[2] In addition to identifying

[1] Another response has been to provide empirical evidence of the relative advantages and weaknesses of rules-based versus principles-based (or judgment-based) accounting standards (e.g., Cuccia *et al.*, 1995; Nelson, 2003; Psaros and Trotman, 2004; Webster and Thornton, 2004).

[2] The reason for research and development (R&D) as our choice for standard is explained in the next section.

and classifying rules and judgments contained in these standards, we compare the level of justification for the rules (including accounting principles) and the level of assistance provided in the standard (e.g., examples and guidance) to support judgments.

For this study, we identify accounting principles by reference to the conventions described in various conceptual frameworks (e.g., the qualitative characteristics, element definitions and recognition and measurement criteria). While this is contestable in terms of the earlier debates on what constitutes an accounting principle (e.g., Moonitz, 1961; Storey and Storey, 1998), standard setters, being the primary beneficiaries, would be expected to apply the conceptual framework in developing standards (Foster and Johnson, 2001).

We adopt a different approach to that in AAA FASC (2003), FASB (2002) and SEC (2003). Our contribution is that we analyse standards that have been through due process and have been used in practice. We use actual principles-based standards, rather than reconstructed rules-based standards, as hypothetical examples of principles-based standards (e.g., AAA FASC, 2003; FASB, 2002; and SEC, 2003) to develop an understanding of the distinction between rules-based standards and principles-based standards. For example, the SEC (2003, p. 10) concludes that the shortcomings of rules-based standards are that they contain numerous bright-line tests, numerous exceptions, and voluminously detailed implementation guidance. However, they provide no evidence for this claim.

We conclude that the rules-based versus principles-based distinction is not meaningful, except in relative terms. Our analysis reveals that all three standards reviewed comprise rules, many of which are supported by principles. Furthermore all three standards, to a varying degree, require the exercise of professional judgment. We observe that the less conservative standard requires more rules and more judgments. We also note that IFRS acknowledge the use of professional judgment and require an assessment of the fair presentation of the financial statements. This is much wider than the U.S. practice of assessing the fair presentation in accordance with generally accepted accounting practice. Based on this limited sample, we tentatively infer the perception that a standard is principles-based may arise from having more requirements to professional judgment (e.g., accounting for the substance of a transaction). Finally, we note some potential issues that might arise in converging with or adopting IFRS.

METHODOLOGY

Choice of Accounting Jurisdictions

Consistent with observations made in Schipper (2003) and SEC (2003), we chose a U.S. standard to represent the purported rules-based approach to standard setting and an international standard to represent a principles-based approach. SFAS 2 requires all research and development expenditure to be expensed when incurred. In contrast, IFRS and other regimes (e.g., Australian, British and New Zealand) require expensing of research expenditure but allow the deferral and amortization of development expenditure if certain criteria are satisfied. Another reason for our choice to compare a U.S. standard and IFRS is because of the joint FASB and IASB convergence project, announced 18 September 2002.

We chose the New Zealand standard as another reference point on the rules-based principles-based continuum. New Zealand accounting standards have a strong relation with international standards.[3] Bradbury (1999) notes that the first accounting standard of a new series issued in 1974 carried the crest of the International Accounting Standards Committee. Thereafter the two sets of standards diverged until 1997, when future standards were to be based on standards issued by the International Accounting Standards Committee or the Australian Accounting Standards Board.[4] On 19 December 2002 it was announced that New Zealand entities would apply International Financial Reporting Standards for periods commencing 1 January 2007, with the option for early adoption from 1 January 2005.

Choice of Accounting Issue

Our selection of the research and development issue was the result of the following criteria. First, an initial list of potential standards was extracted from Mason and Gibbins (1991). They chose eleven U.S. standards from approximately thirty APB Opinions and FASB Statements.[5] Second, for comparability we required a standard that focuses on a narrow economic phenomenon on which both the FASB and the IASB had issued a relatively comparable standard.[6] Third, we chose a standard that contained a significant measurement and recognition issue, rather than being primarily a disclosure issue (e.g., the reporting of cash flow statements). Fourth, it was desirable that the standard was independent of, and therefore preceded, the current rules-based principles-based standards debate.

We note that the standards chosen are from different periods. SFAS 2 was issued in 1974, IAS 9 in 1993 and FRS-13 in 1995. We use the 'Revised 1993' version of IAS 9, which was superseded, in 1999, by IAS 38, *Intangible Assets*. Comparing standards that are issued at different dates allows the possibility of differences due to changes in conceptual frameworks, changes in technology (especially in measurement reliability) and the accumulation of empirical evidence that can be brought to bear on the issue. We do not view this as a weakness,

[3] Our initial expectation was that the New Zealand standard FRS-13 would be similar to IAS 9. However, we found important differences in the choice of 'principles' and in disclosure requirements. These differences highlight the impact that due process has on the content of a standard and suggest implications for convergence and adoption of IFRS.

[4] The harmonization between Australian and New Zealand accounting standards began at an earlier date. In June 1994, the Accounting Standards Review Board (New Zealand) and the Australian Accounting Standards Board issued identical policy statements supporting harmonization between the two countries.

[5] The criteria used by Mason and Gibbins (1991) were that these best represented standards that (a) dealt with a broad issue comprehensively, (b) were not limited to a specific industry and (c) were not wholly or substantially superseded.

[6] This criterion eliminated many standards where there was not a one-to-one correspondence between national and international standards.

as our purpose is not to create a 'horserace' for the 'best standard'. Rather, it is to undertake a comparative analysis of a purported rules-based standard with a purported principles-based standard.

Procedures

One of the first difficulties encountered in analysing comparative accounting standards is that they are structured differently in different jurisdictions. U.S. standards comprise an introduction and standards with appendixes for background information and basis for conclusions. International standards (IAS) comprise an introduction (objectives and scope), definitions, standards (black letter) and commentary (grey letter). The New Zealand standard (FRS) has similar construction to an IAS and has an appendix containing a comparison of the standard with international and Australian Accounting Standards. We omitted the background section in SFAS and the comparative appendix in FRS-13 from our analysis, as these sections have no equivalent sections in the other standards. We also ignored transitional provisions in each standard.

We analysed each accounting standard to identify the number and type of rules and judgments, together with the justification for those rules (e.g., reference to accounting principles) and the assistance provided in the standard for any judgments that are required. Similar to Mason and Gibbins (1991), our unit of analysis is a 'phrase'. That is, we define a phrase as one rule, one principle, one judgment or one item of assistance to support the judgment. In many cases a phrase is a paragraph. However, in some cases we grouped related paragraphs into a single phrase and subdivided other paragraphs into several phrases. For example, each sub-paragraph in SFAS 2, 11 (a) to (e) was recorded as a separate phrase. SFAS 2 paragraphs 30 and 31 were considered as one phrase and coded 'other justification—using exposure draft responses as justification'. To provide a common framework across all standards we allocated each 'phrase' to one of the following sections: introduction and scope, recognition, measurement (including both initial and subsequent measurement) and disclosure. The Appendix provides an example of our coding.

We did not undertake word counts. It was not our purpose to count how many times a word (e.g., comparability) was used but rather the number of times the principle was invoked in each section. Similarly, required disclosures were only counted as one 'disclosure-rule' even if there were more than one reference in the standard (e.g., paras 27 and 30(e)(iv) in IAS 9).

To mitigate concern that our phrase coding was not always clear-cut, two authors undertook the assessment independently and then negotiated an agreed outcome. The third author then reviewed this outcome.

COMPARATIVE ANALYSIS

Rules and Justification

Table 1 presents a comparative analysis of the number of rules and justification for those rules provided in each standard. Panel A of Table 1 summarizes the number of rules contained in each section of the standard, while the appeals to

Table 1

COMPARATIVE ANALYSIS OF THE NUMBER OF RULES AND JUSTIFICATIONS

	SFAS 2	IAS 9	FRS-13
Panel A: Number of rules in each section of the standard			
Introduction and scope	2	2	2
Recognition	1	3	2
Measurement	7	7	8
Disclosure	1	8	12
	11	20	24
Panel B: Number of references to principles in each section of the standard			
Introduction and scope	1	1	1
Recognition	6	1	–
Measurement	2	3	4
Disclosure	1	–	–
	10	5	5
Panel C: Nature of the principles referenced			
Asset recognition	–	1	1
Asset recognition—probability/uncertainty of future economic benefits	1	2	1
Asset recognition—reliability of measurement	–	–	1
Comparability	4	–	1
Confidentiality	1	–	–
Exchangeability[a]	1	–	–
Matching[a]	1	–	–
Prudence	–	1	–
Separability	1	–	–
Substance (risks and benefits)	–	1	1
Usefulness	1	–	–
Panel D: Number of 'other' justifications in each section of the standard			
Recognition	2	–	–
Measurement	3	–	–
	5	–	–
Panel E: Analysis of 'other' justifications			
Another accounting standard	1	–	–
Exposure draft submissions	2	–	–
Present accounting practice	2	–	–

[a] Reference to exchangeability and matching relates to the non-application of these accounting principles, whereas the other principles in Panel C denote an appeal to these principles.

accounting principles and 'other justification' are reported in Panels B and D. Panels C and E provide further detail on the accounting principles employed and the nature of the other justification.

The most striking observation from Table 1, Panel A, is that the purported rules-based standard (SFAS 2) has the least number of rules (11), relative to purported principles-based standards IAS 9 (20) and FRS-13 (24). Furthermore, Panel B shows that SFAS 2 is supported by more references to accounting principles (10) than IAS 9 (5) and FRS-13 (5).

The reason there are fewer rules in SFAS 2 is that it adopts a more conservative position (i.e., it expenses both research and development expenditure), whereas both IAS 9 and FRS-13 require expensing of research expenditure but capitalization and amortization of development expenditure. Hence, IAS 9 and FRS-13 require recognition rules and more disclosure rules. Having permitted only one method of accounting for research and development, SFAS 2 requires a lower level of disclosure (SFAS 2, para. 62). IAS 9 has fewer disclosure rules than FRS-13 because IAS 9 'encourages' two items of disclosure that are required by FRS-13 (i.e., a description of research activities and circumstances or events that led to impairment; IAS 9.31).[7] This difference may be more to do with scope of application of the accounting standard than a difference in approach. IFRS apply to financial statements, whereas New Zealand FRS apply to the annual report (which includes the financial statements and non-financial statement information).

One of the major differences in approach between SFAS 2 and IAS 9 relates to measuring the cost of research and development. SFAS 2 contains a list of elements of cost that 'shall be identified with research and development activities' (SFAS 2, para. 11(a) to (e)). We coded this list as seven rules (including three judgments). IAS 9.12 contains a similar list that is preceded by the following definition: 'Research and development costs should comprise all costs that are directly attributable to research and development activities or that can be allocated on a reasonable basis to such activities' (IAS 9.11).

In IAS 9 (and FRS-13) the definition takes precedence. The list provides examples and guidance of what to 'include' in research and development costs 'when applicable'. This admits the possibility that there might be items not on the list that are research and development and that items on the list might not be applicable in a particular circumstance. Even though the practical effect of the standards may be the same, the list in IAS 9 acts as a series of guidelines and examples rather than a set of rules.

Analysis of Principles

Because standard setters would be expected to apply the conceptual framework in developing standards, we identify accounting principles by reference to the conventions described in various conceptual frameworks (e.g., the qualitative characteristics, element definitions, and recognition and measurement criteria).

[7] The 'encouraged' disclosures in IAS 9 are classified as judgments, whereas the same items are required disclosures in FRS-13 and are therefore rules.

We note that each standard has at least one specific reference to the relevant conceptual framework.

Table 1, Panel B, indicates that all three standards are grounded in principles. As SFAS 2 is based on the non-recognition of research and development as an asset, the section dealing with recognition contains the most references to accounting principles. Whereas, in IAS 9 and FRS-13 the measurement section contains the most references to accounting principles. In terms of the principles referenced (Panel C), SFAS 2 is heavily weighted on the principle of comparability. Wolk *et al.* (1989, p. 236) distinguish between finite and rigid uniformity. Finite uniformity attempts to equate prescribed accounting methods with the relevant circumstances in generally similar situations. Rigid uniformity is prescribing one method for generally similar transactions, even though relevant circumstances may be present. Wolk *et al.* (1989) describe SFAS 2 as an example of rigid uniformity because research and development costs must be expensed even though future benefits may be present.

Panel D reports the other justification in the standard. There is a bias in this panel because SFAS 2 contains a Basis for Conclusions, which does not exist in IAS 9 and FRS-13. We include the SFAS 2 Basis for Conclusions in our analysis because it contains references and justification for the accounting rules employed. This is similar to 'grey letter' commentary paragraphs in IAS and FRS. However, the SFAS 2 Basis for Conclusions also contains non-principle-based justification (e.g., appeal to other standards, current practice and ED submissions). The SFAS 2 Basis for Conclusions also refers to accounting principles that have been discussed and not applied (i.e., matching and exchangeability). Whereas IAS 9 and FRS-13 only discuss the principles applied.

The New Zealand *Statement of Concepts* (SC) is different from the International Accounting Standards Board (IASB) *Framework for the Preparation and Presentation of Financial Statements* in that both 'prudence' (SC 6.9) and 'matching' (SC 7.25) are described as unacceptable accounting principles. It would therefore be redundant to include a discussion of these principles in FRS-13. This suggests that even small differences in conceptual frameworks can alter the content of standards and possibly the perceptions of whether the standard appears rules-based or not.

Judgments and Supporting Assistance

Table 2 presents a comparative analysis of the number of judgments required in each standard and the items of supporting assistance.[8] Panel A of Table 2 provides the number of judgments required in each section of the standard and Panel B analyses the type of judgment required. Panel C analyses the type of supporting assistance for judgments contained in the standard.

Table 2 reveals that the purported rules-based standard (SFAS 2) requires fewer judgments than the purported principles-based standards (IAS 9 and

[8] This is similar, but not identical, to the classification of professional judgments in Mason and Gibbins (1991). The main difference is that there is no word count on 'judgment' (as we are interested in the number of judgments not the number of times the word is used). Nor do we analyse probabilistic words (e.g., 'significant', 'probable', 'major'). However, these terms assisted us in identifying judgments.

TABLE 2

COMPARATIVE ANALYSIS OF JUDGMENTS AND SUPPORTING ASSISTANCE

	SFAS 2	IAS 9	FRS-13
Panel A: Number of judgments in each section of the standards			
Scope	–	1	1
Recognition	–	7	7
Measurement	3	5	7
Disclosure	–	2	–
	3	15	15
Panel B: Analysis of type of judgments required			
Allocation	1	2	2
Demonstrate	–	3	3
Disclosure	–	2	–
Forecast	–	3	4
Identify	2	3	4
Intention	–	1	1
Reliably measure	–	1	1
Panel C: Analysis of supporting assistance for judgments			
Acknowledgment of judgment	–	3	3
Definitions	2	2	2
Examples			
Scope	–	1	1
Recognition	2	3	3
Measurement	–	5	5
Guidance	–	5	5

FRS-13). The type of judgments required is illustrated in the following examples. In order to recognize development costs as an asset the entity is required to 'identify' the product or process clearly and 'reliably measure' the costs attributable (i.e., an 'allocation') to the product or process (IAS 9.17(a)). Other judgments require 'demonstrating' the technical feasibility of the product or process (IAS 9.17(b)) and having the 'intention' to produce, market or use product or process (IAS 9.17(c)). Impairment requirements of capitalized development expenditure require a 'forecast' of future economic benefits and further development costs (IAS 9.17). As noted earlier, IAS 9 has two additional encouraged disclosures that we have classified as judgments in IAS 9 but rules in FRS-13.

IAS 9 and FRS-13 have more phrases that provide assistance for making the required level of judgments. These include the 'acknowledgement' that judgment is required and the use of 'definitions', 'examples' and 'guidance'. For example, IAS 9.23 'acknowledges' the difficulty created by technological and economic obsolescence for estimating further costs and future revenues beyond a short period. The same paragraph creates 'guidance' by stating that development costs are normally amortized over a period not exceeding five years. In addition to this guidance, FRS-13 (5.12) includes a bright-line rule that limits the amortization period to a maximum of twenty years.

DISCUSSION

In the previous section we provided the numerical results of our analysis. In this section our interpretation of these results is offered in order to stimulate further debate. Alternatively, given the small sample size from which they are based, the conclusions can be regarded as hypotheses to be discussed and empirically tested by future research.

Rules and Principles

Our analysis shows that all three standards contain rules. Furthermore, all three standards are based on principles. Thus the terms 'rules-based' and 'principles-based' are not meaningful descriptions of these accounting standards.

The AAA FASC (2003) considers that the standard setting process and its products may be viewed as a continuum. At one end are rigid rules and at the other economics-based concepts that require the application of judgment. We consider a pure principles-based standard would not exist (preparers could simply rely on the conceptual framework). Thus, the fact that a standard exists at all means that some rules are needed to either clarify the conceptual framework or to stop potential accounting abuse. Unless the rules are *ad hoc* they will be based on principles. However, the standard will differ (a) because of the weighting given by standard setters to qualitative characteristics in the conceptual framework, and (b) because of the number and nature of professional judgments required.

For research and development accounting, our analysis shows that the more conservative standard (i.e., the no recognition rule in SFAS 2) contained fewer rules.[9] The less conservative standards (i.e., IAS 9 and FRS-13) contained more rules and more professional judgments (and therefore supporting phrases). The conservatism of a standard is the result of the weighting given to specific qualitative characteristics. While the FASB and IASB have similar (but not identical) conceptual frameworks, neither provides a guide for choosing between qualitative characteristics. Yet it is the weighting given to these criteria that can give rise to different standards.

We do not develop taxonomy of the rules contained in the standards but we observe that there are various levels and types of rules. There are 'hard rules' that

[9] By conservatism, we mean the implicit value of the asset is assumed to be zero and the associated cost of the asset acquisition is expensed. It might be argued that conservatism is not a necessary condition. That is, the standard could contain a single, non-conservative rule that required capitalization. However, rules requiring cost capitalization or value estimation would still need further rules for remeasurement (i.e., impairment and amortization) and continuing disclosures.

determine in advance what conduct is permissible (e.g., expense all research and development expenditure when incurred [SFAS 2, para. 12]) and 'soft rules' that require judgment (e.g., the costs of materials that have an alternative future use shall be capitalized as tangible assets when acquired or constructed [SFAS 2, para. 11(a)]).[10] Bright-line rules appear at the operational or implementation level of the standards. There are 'hard' bright-line rules (e.g., specifying the maximum amortization period of twenty years [FRS-13, 5.12]) and 'soft' bright lines that provide guidance (e.g., development costs are normally amortized over a period not exceeding five years [IAS 9.23]). Given that some bright-line rules can assist judgment, we disagree with the SEC (2003) and FASB (2004) that principles-based standards should be devoid of bright lines. There are hard disclosure rules (e.g., the entity is required to describe its research and development activities in its financial report [FRS-13, 5.20]), and soft disclosure requirements (e.g., an entity is encouraged to include a description of its research and development activities [IAS 9.31]).

Drafting

Why is it that U.S. standards are commonly perceived to be rules-based? Differences in drafting may give this impression. For example, SFAS 2 provides a set of rules on the elements of cost, whereas IAS 9 (and FRS-13) provides a general definition followed by examples and guidance. SFAS 2 will appear more rules-based even if there is no difference in the application by practitioners of this part of the standard.

Nelson (2003) notes that the IAS regime is a relatively younger standard setting regime than the FASB and therefore they have had less time to accrete rules. Our analysis provides some support for this hypothesis.[11] We note (Table 1, Panel E) that SFAS 2 makes a reference to APB Opinion No 16 in its Basis for Conclusions. However, this may not be a fair test as SFAS 2 is a relatively older standard and is not likely to capture the potential cross-referencing that would be within a more recent standard.

Uniformity, Comparability and Economic Substance

From Table 1, Panel C, it is the weighting given to 'comparability' relative to 'substance' that has the major impact on the conservatism of the standard and hence the perception that it is rules-based. The rigid uniformity in SFAS 2 arises from a substantial weighting on comparability, in contrast with IAS 9 that is based on substance over form.[12] However, the issue of uniformity goes beyond SFAS 2 (for

[10] Kaplow (1992) uses this distinction in the context of whether legal commands should be promulgated as rules or standards. He uses the term 'standards' for what we have described as 'soft rules'. Under his terminology a standard leaves the adjudicator to decide on factual issues and what conduct is permissible.

[11] Although we note that both the IASC and FASB were formed in 1973.

[12] The conceptual base for SFAS 2 is APB 4. Ironically, the term 'substance over form' is mentioned prominently in APB Statement 4 (1970, paras 25 and 127) as a 'basic feature' of financial accounting. However, the phrase is only used in passing in SFAC 2 (1980, para. 160).

an historical perspective see Merino and Coe, 1978). For example, Schipper (2003) suggests it is the desire for comparability and consistency that is the reason for accounting standards. Thus, relevance and reliability assist in the standard setting process once it is agreed that comparability is desirable. On the other hand, the AAA FASC (2003) states that economic substance not the form of any given transaction should guide standard setting. It specifies that a concepts-based standard should focus on the primary characteristics of relevance and reliability and view uniformity as secondary.

Professional Judgment and the True and Fair View Override

Our analysis indicates that IAS 9 and FRS-13 contain more acknowledgement of and support for professional judgments than SFAS 2. In particular, IFRS and FRS rely heavily on principles that require an overlay of professional judgment, such as determining 'substance of the arrangement'.[13] This is equivalent to the economic-based approach discussed by the AAA FASC (2003). This 'professional judgment overlay' occurs at two levels. At the transaction or event level it results in accounting for the economic substance of the transaction not the form (AAA FASC, 2003). In some jurisdictions (i.e., Australia, New Zealand and the U.K.) and in the IASB framework, the overlay of professional judgment also applies at the financial statement level in the form of a 'true and fair view' override. In the U.S. the term used is 'fairly present in conformity with GAAP'. However, Mason and Gibbins (1991) note that the explanation of this phrase in the American Institute of Certified Public Accountants' SAS 5 is not well articulated in accounting standards and contributes to a dependence on GAAP. In contrast, the true and fair view override has been a long standing cornerstone of British-based corporation law regimes (see Chambers and Wolnizer, 1991).

We note that the context in which the standards apply also reflects differences in the acknowledgement of the use of professional judgment. For example, New Zealand has a general introduction, the 'Explanatory Foreword', which applies to all standards. The 'Explanatory Foreword' states that the purpose of the financial report is to fairly present, or to provide a true and fair view of, the entity's performance and position. While it acknowledges the importance of generally accepted accounting practice (GAAP) and approved accounting standards, it admits the possibility that following GAAP may not lead to a fair presentation (para. 5.1). Furthermore, it suggests the choice of an appropriate accounting policy is 'a matter of professional judgment' (para. 4.6).[14]

Acknowledgment of a meta-level professional judgment requirement is a major cornerstone in the application of principles-based accounting rules. Mason and Gibbins (1991) consider that the absence of a general reference to professional judgment in applying FASB and APB standards may contribute to pressure for more detailed standards.

[13] The term 'substance over form' can be traced to, at least, the late 1920s (Clarke and Dean, 1992).

[14] Other jurisdictions (e.g., Canada and the U.K.) also have a general introduction. IAS 1 also contains the concept that 'fair presentation' is more than compliance with a set of standards.

The SEC (2003, p. 30) dismisses the 'true and fair view override' as a necessary component of principles-based standards because under an objectives-oriented regime the accounting should, in virtually all cases, be consistent with the standard setter's view of the nature of the economic arrangement.[15] This argument ignores the application of the true and fair view override to the financial statements as a whole, not to specific standards. This means that the true and fair view override can be invoked even when there are no standards that cover the particular transaction being considered. Furthermore, the move away from a checklist mentality will require more than objectives-oriented standards. It requires a behavioural change. The true and fair view override is the cornerstone of professional judgment.

Beyond Accounting Standards

The standard setting process, even with identical conceptual frameworks, may not achieve identical standards or even convergence. First, the weighting of framework criteria is not a simple task (Joyce *et al*., 1982). Second, standard setting is a political process (e.g., Hope and Gray, 1982) and there are outside factors that will influence the weighting put on conceptual arguments. For example, the prevalence of lawsuits in some jurisdictions may force the adoption of conservative accounting practices (Bierman and Dukes, 1975). Environments, such as the US, with high expected litigation may also give rise to the demand (and supply) of interpretations to accounting standards (Pacini *et al.*, 2000; Nelson *et al*., 2002). On the other hand, a principles-based environment needs to be supported by education that emphasizes the development of the competency to make sound professional judgments.

CONCLUSION

There is a commonly held view that the FASB's standards are rules-based and the IASB's standards are principles-based. This article sought to identify the basis of this distinction by analysing actual standards that have been through due process, compared to prior research which has mainly focused on reconstructed or hypothetical examples of principles-based standards.

Our comparison of research and development standards across three different jurisdictions leads us to conclude there are two major issues that standard setters need to consider in moving towards more principles-based standards. The first is to reduce the weighting given to comparability and consistency, relative to other qualitative characteristics in the conceptual framework. The second is to increase the allowance of professional judgment in standards at the transaction level (i.e., to account for the economic substance of the transaction) and at the financial statement level (i.e., to apply the true and fair view override).

These conclusions have implications for due process and, in particular, for the FASB–IASB convergence project and the adoption of IFRS by other jurisdictions

[15] For a more detailed criticism of the SEC Report with regard to the true and fair view override see Benston *et al.* (2005).

(e.g., Europe and Australia). Our analysis has shown that the choice of principles within the standard, together with the explanation and justification of those choices, will depend on how the conceptual framework is written. For example, the weighting given to comparability, relative to relevance and reliability, needs to be explicit. This suggests that a single conceptual framework is needed prior to any convergence project.

Our conclusions are based on the comparative content of research and development standards across three jurisdictions. Analysing other accounting standards may yield further insights.

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APPENDIX A

DESCRIPTION OF CODING

Panel A: Extract of IAS 9 paragraphs 4 and 5

4. An enterprise may carry out research and development activities under contract for another enterprise. When the substance of the arrangement is such that the risks and benefits associated with the research and development activities are, or will be, transferred to the other enterprise, the enterprise conducting the research and development activities accounts for the costs in accordance with IAS 2, Inventories, or IAS 11, Construction Contracts. The recipient of the risks and benefits accounts for its costs in accordance with this standard.

5. When the substance of the arrangement with the other enterprise is such that the risks and benefits associated with the research and development activities are not, or will not be, transferred to others, the enterprise conducting the research and development activities accounts for the costs in accordance with this standard. Factors which indicate that the risks and benefits of research and development activities are not transferred to others include: the enterprise conducting the research and development activities is contractually obliged to repay any of the funds provided by the other enterprise, regardless of the outcome of the research and development activities; and even though the contract does not require the enterprise conducting the research and development activities to repay any of the funds provided by the other enterprise or surrounding conditions indicate that repayment is probable.

Panel B: Extract of coding for IAS 9 paragraphs 4 and 5

	A Paragraph	B Black/grey	C Section	D Type	E Description	F Judgment	G Type
1	4	G	Scope	Rule 20	Does not apply to subcontract, use IAS-2 or -11	1	Identification
2	4&5	G	Scope	Principle	Risk and benefits, for judgment in rule 20	0	
3	5	G	Scope	Example	Examples (2) for rule 20	0	

Panel C: Discussion

Paragraphs 4 and 5 are combined and partitioned into three ‘phrases’. Column B reports whether the phrase is black letter or grey letter. For SFAS 2 column B was coded either ‘standards’ or ‘basis for conclusion’. Column C records one of four sections used of the accounting standard: introduction and scope, recognition, measurement, or disclosure. Column D records our judgment on the type of phrase and E a brief description. Column F records whether a judgment is involved and column G the type of judgment.

Row 1 records the rule (a sequential reference number) that the scope of the standard does not apply to research and development activities under contract for another enterprise. This rule requires judgment in identifying whether this situation exists. In row 2 the underlying principle, of whether the risks and benefits associated with the research and development are transferred, is recorded. Row 3 records the examples provided in paragraph 5 to support the judgment in rule 20.