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WHY CONSISTENCY OF ACCOUNTING STANDARDS MATTERS: A CONTRIBUTION TO THE PRINCIPLES – VERSUS - RULES DEBATE IN FINANCIAL REPORTING

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ABSTRACT

Currently, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) are undertaking a project to develop a common conceptual framework that …is both complete and internally consistent. Such a framework would provide a sound foundation for developing future accounting standards and is essential to fulfilling the Boards' goal of developing standards that principles-based, internally consistent, internationally converged, and that lead to financial reporting that provides the information needed for investment, credit, and similar decisions. That framework, which will deal with a wide range of issues, will build on the existing IASB and FASB frameworks and consider developments since they issued their original frameworks. An overview of the importance of the Framework, why the existing Framework does not fully meet the needs of the IASB, FASB, and other accounting standard setters, and the need to revisit document are discussed in Bullen and Crook (2005) and Johnson (2004a. b. and 2005).. As explained in these IASB and FASB staff papers, several gaps in the Framework need to be fulfilled and a number of areas need to be updated. A cross-firm consistent application of accounting standards is sought in all major accounting systems. Since many transactions and events are only vaguely or not explicitly addressed in the standards managers must often use judgment when applying accounting standards to particular transactions or events. This analysis concludes that a consistent application of accounting standards can only be ensured if the accounting standards themselves are internally consistent. By contrast, inconsistent standards— in the absence of clear guidance—permit managers to (more or less arbitrarily) choose between different accounting methods. Moreover, it is found that a consistent application presupposes the existence of specific guidance ('rules') in order to frame management's judgment. It is argued that the reliance on principles only—as requested by many in the accounting literature—fails to ensure a consistent application because it allows management to exert judgment differently in identical cases. The assessment includes arguments and propositions from the international discussion in the accounting literature and also refers to other related fields of research, such as legal theory.

KEYWORDS

Conceptual framework; Accounting Choices; Principles vs. Rules Debate; Standard Setting.

1. INTRODUCTION

Ever since the occurrence of accounting scandals such as Enron in the beginning of the millennium, the principles-versus-rules debate has been on top of the agenda of securities regulators, especially of the U.S. Securities and Exchange Commission (SEC), and of national and international standard setters and accountancy bodies, such as the U.S. Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB).and the Institution of Chartered Accountants of India (FASB,2002,2004; Tweedie, 2002, 2005, SEC, 2003; ICAI, 2006). The topic has been controversial in national and international journals.

The origins of the discussion go back to the early twentieth century. Until then, practitioners in the U.S. and elsewhere failed to implement uniform accounting standards. They argued that the choice of accounting methods, which appropriately reflect the economic substance of specific transactions and events, requires the use of professional judgment (Previts and Merino, 1998, p. 163). That is, 'the application of relevant knowledge and experience, within the context provided by... accounting standards... in reaching decisions where a choice must be made between alternative possible courses of action' (Mason and Gibbins, 1988). However, with the proliferation of different opinions about the proper accounting methods and the crash of the U.S. stock market in 1929, there was a call for the establishment of uniform accounting standards which would limit management's use of professional judgment and enhance the comparability of financial statements (Previts and Merino, 1998, pp. 161 et seq.). Since then it has been widely accepted that 'by articulating the best thinking about the issues, accounting standards will produce better financial reporting, at least on the average, than would exist in their absence' (Mason and Gibbins, 1991, p. 21). In the U.S. the call for comparability has, amongst other things, led to what may be called an excessive overregulation. As a consequence of the corporate accounting scandals some of the accounting literature expresses concerns with rules-based accounting and there are increasingly calls for a principles-based approach to standard setting (FASB, 2002, 2004; SEC, 2003).

Another topic that plays a major role in the planned reformation of the world's prevailing accounting systems—IFRS and U.S. GAAP—is the elimination of inconsistencies and thus the quest for internal consistency of the respective systems (IASB, 2008, P4, BC2.46). The accounting literature distinguishes between two notions of consistency: on the one hand internal consistency of accounting standards, and on the other hand consistency in the application of those standards. While internal consistency requires that 'any individual standard adopted should be consistent with the existing system of standards'), consistency in the application 'refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities' (IASB, 2008, QC16).

Internal consistency as well as application consistency across companies has traditionally been sought in all major accounting systems. Interestingly, the reasons for the pursuit of this objective are quite different in different systems. FASB Concepts Statement No. 2 proposes that the U.S. Conceptual Framework 'is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards' and emphasizes the need for a cross-firm consistent choice of accounting policies by stating that 'the public is naturally skeptical about the reliability of financial reporting if two enterprises account differently for the same economic phenomena' (CON 2.16). It explains the need for consistency in relation to comparability: 'Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance' (CON 2.111). In their draft for a revised conceptual framework the FASB and the IASB similarly point out that 'although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability and, therefore, may be undesirable' (IASB, 2008, QC19).

One can observe that the different notions of consistency are related in such a way that consistency in the application of accounting standards across companies can only be achieved if the standards are internally consistent. In a system that provides clear rules for each and every accounting issue and in which the application of the rules does not require the use of any judgment, internal consistency between the rules would not be required because consistency in the application across companies would be achieved anyway (AAA FASC, 2003, p. 74). However, such a system does not exist. The continuous issuance of new accounting standards and interpretations in rules-based systems, such as U.S. GAAP reveals that there are always issues not covered by any existing rule as well as rules the application of which requires management to use judgment (Penno, 2008, p. 339). In more principles-based systems, like IFRS, the application of high-level principles to specific accounting issues demands the exertion of judgment in many cases.

In particular judgment is necessary either if a transaction or event is not covered by any accounting standard or if it is only addressed by rather broad principles. In such cases management shall, according to IFRS, develop an accounting policy or interpret the principle by reference to the requirements and guidance in

standards dealing with similar and related issues. If the standards addressing similar transactions or events are not consistent with each other, different companies may make different interpretations and choices and thus apply different accounting policies to identical cases. Researchers supporting principles-based accounting standards argue that the restriction of management's judgment that follows from the objective to achieve a consistent application may sometimes impair the relevance of financial reporting information, which they regard to be more important than consistency and comparability (Alexander and Jermakowicz, 2006, p. 150).

Obviously, the rule-versus-principles debate and the discussion on consistency are related. Our article contributes to this debate by addressing two major issues Initially, the traditional quest for consistency in the application of accounting standards is a given and the analysis considers how the current IFRS system would have to be changed with regard to internal consistency of accounting standards as well as to the relationship between principles and rules in order to achieve consistent application. The emphasis then is on present and possible future IFRS, but U.S.GAAP is relied on also because most of the arguments brought forward in the comprehensive U.S. accounting literature equally apply to IFRS. IFRS and U.S.GAAP are paradigmatic for accounting systems under which the accounting regulation is developed by private standard-setting institutions and do not have immediate legal status.

The second major research question addressed is whether the benefits of principles-based accounting standards, such as an increase in relevance, outweigh the loss of consistency in the application. For this discussion, the previous assumption of consistent application of accounting standards by all companies is relaxed, enabling critical discussion of the advantages and disadvantages of principles-based and rules-based accounting standards. For reasons of comparability, enforceability and objectivity of financial reporting information, it is concluded to be important to have specific (internally consistent) accounting requirements that limit management judgment in the application of accounting standards to ideally only one possible accounting method. We acknowledge, however, that this may, in some situations, lead to an impaired relevance of financial reporting information.

TOWARDS CONSISTENCY IN NORMATIVE ACCOUNTING FRAMEWORKS

The quest for internal consistency is shown here to have developed in different accounting systems. We conclude that a consistent application of accounting standards does not only presuppose the existence of internal consistency of high-level concepts and principles, but also that the rule maker (and managers in the absence of specific guidance) applies the concepts and principles consistently to all comparable accounting issues. This implies that in an internally consistent accounting system there is, in principle, for each transaction and event only one accounting method that accords to the high-level principles as well as to the specific guidance relating to comparable accounting issues and thus consistently fits into the entire 'system' of norms.

U.S. GAAP, and also IFRS all require the use of judgment in the application of accounting standards/norms. Board members and managers under U.S. GAAP and IFRS are supposed to balance between and apply the general concepts to specific cases according to their personal professional judgment, which may differ from case to case. This implies that for some issues there may be several different accounting methods that are all in compliance with the Framework and between which the Board members or management may hence choose.

Consistent application implies that comparable issues are accounted for in the same way across companies (Schipper, 2003, p. 62). We argue that this can only be achieved if standard setters (and managers in the absence of clear guidance) trade-off between and apply the general concepts, such as relevance and reliability, as well as the general recognition and measurement principles consistently to all comparable cases. In an internally consistent accounting system there can be hence for each accounting issue only one accounting method that accords to the high-level concepts principles as well as to the specific guidance relating to comparable accounting issues.

IMPOSSIBILITY OF CONSISTENCIES

Alexander and Alexander and Jermakowicz (2006) point out that accounting 'is most certainly not a pure science' and conclude that 'internal consistency, as an absolute, is simply not possible'. In another article Alexander (2006) claims that companies' indifferent countries will apply IFRS inconsistently in identical cases and that the enforcement of accounting regulation must accept this. We agree that accounting is not a 'pure science' (see above) and that absolute consistency of all accounting principles is not achievable. Indisputably, one can also agree with Alexander's assumption that IFRS will never be interpreted and applied fully consistently by all companies. However, as in the case of other ideals, such as justice, equality and freedom, the impossibility of achieving absolute internal consistency does not, from a normative perspective, imply that consistency between accounting norms and their consistent application is not to be desired. Nor does it imply that on a comparative basis there cannot be more consistent and less consistent accounting norms.

THE ROLE OF CONSISTENCY IN THE IFRS SYSTEM

We now turn to exploring how far internal consistency is achieved in the IFRS system. The IASB Framework is shown to contain contradictory objectives and qualitative characteristics as well as conflicting general concepts and principles. As a result, Standards and Interpretations dealing with similar and related issues are partly inconsistent. From this finding one can infer that a consistent application of IFRS is currently not ensured. Finally, the IASB's efforts towards the elimination of the described inconsistencies are presented.

THE QUALITATIVE CHARACTERISTICS 'RELEVANCE' AND 'RELIABILITY'

It is clear the IASB strives for consistency of its standards. According to the Preface to International Financial Reporting Standards 'the objective of the Framework is to facilitate the consistent and logical formulation of IFRSs' (Para. 8). Moreover, in their proposal of a revised conceptual framework the FASB and the IASB note that 'internal consistency of accounting standards is desirable and that it should naturally result from developing standards that are consistent with the same conceptual framework' (IASB, 2008, BC2.46). Consistent with the U.S. Conceptual Framework the IASB Framework (1989) points out that the Board members in the standard setting process and managers when developing accounting policies for unregulated issues need to trade-off between qualitative characteristics, especially relevance and reliability (FW.45). However, at present, there is no unanimous agreement on what constitutes relevant and reliable information or on how to trade-off adequately between the two qualitative characteristics (Johnson, 2005, p. 1). And more recently, the question of whether such a trade-off should exist has been raised. Whether an accounting method provides relevant information depends, amongst other things, on the objective of financial statements and the underlying explicit or implicit accounting theory. If, as according to Sprouse and Moonitz (1962), the objective of financial statements is to provide information about the financial position and changes in the financial position of an enterprise, information about the enterprise's wealth as indicated by its resources (assets) and obligations (liabilities) is considered as relevant (assets/liabilities view). If, as according to Paton and Littleton (1940: 1965), the objective of financial statements is to provide information about the performance of an enterprise, information about the enterprise's efficiency in obtaining inputs to produce and sell outputs as indicated by net periodic profit is regarded as relevant (revenue/expense view). The differences of the two objectives and the related accounting theories as well as, arguably, the impossibility to pursue both at the same time has been evidenced in the Anglo-American literature on accounting theory since the 1920s and lately Ronen (2008, p. 184–5) are examples in the Anglo-American literature.

The existing IASB Framework contains both opposing and inconsistent objectives (FW.15; IAS 1.7). As a consequence, standards contain recognition and measurement principles that reflect different accounting theories and are thus sometimes inconsistent. The following example illustrates the resulting inconsistencies: The IASB has given priority to the revenue/expense view in the recognition of government grants, since the corresponding income shall be allocated over the periods necessary to match them with the related costs (IAS 20.12. By contrast, in the case of biological assets the IASB has given priority to the assets/liabilities view because income shall be recognized independently from the incurrence of the costs when an increase in wealth (indicated by an increase in the asset's fair value) has taken place (IAS 41.12, 41.26).

Furthermore, the existing IASB Framework does not 'convey … the meaning of reliability clear enough to avoid misunderstandings' (IASB, 2008, BC2.11). The IASB (2005a) notes that 'for many [Board members], the meaning seems to be verifiability, for some its precision, for some, it may be faithful representation, for a few perhaps all of those plus neutrality. Among constituents, the differences in meaning are much greater.

In cases where the qualitative characteristics 'Relevance' and 'Reliability' suggest different accounting policies, the IASB in the standard setting process and managers in the development of accounting policies when no IFRS addresses the particular transaction or event, need to trade-off between the two qualitative characteristics(FW.45). The IASB Framework does not provide guidance on how to balance relevance and reliability, but rather requires managers to find an appropriate balance between the characteristics by using their professional judgment (FW.45). In the absence of legal liability this may be tolerable. Given the threat of different assessments in court this imposes an undesirable risk on management even if assessment and application are done in good faith.

The FASB points out that 'no consensus can be expected about their relative importance in a specific situation because different users have or perceive themselves to have different needs and, therefore, have different preferences' (CON2.45). The diverging opinions about the relative importance of relevance and reliability in the accounting literature confirm this statement. For example, Ernst &Young (2005) regard reliability as 'a necessary precondition that must be met for information to be relevant' (p. 2). By contrast, Chambers (1996) argues in the context of measurement that the qualitative characteristics are mutually exclusive and that a trade-off results in information that is neither relevant nor neutral (reliable) (p. 127).

Joyee et al. (1982) evidence the low agreement on the meaning and relative importance of the qualitative characteristics by means of an experiment which they claim results in users choosing different accounting policies in identical situations. According to them, 'this casts doubt on the ability of the qualitative characteristics... to facilitate accounting policy making'. One may conclude from these findings that the qualitative characteristics of relevance and reliability do not enable Board members as well as managers in the absence of clear guidance to consistently exercise their professional judgment in the development and application of accounting policies relating to comparable issues.

THE GENERAL DEFINITIONS, RECOGNITION CRITERIA AND MEASUREMENT CONCEPTS

Solomon's (1986, pp. 120–1) and Dopuch and Sunder (1980, pp. 6–7) demonstrate by reference to pension obligations and deferred taxes that the liability definition under U.S. GAAP is too broad to be helpful in choosing between different accounting policies. This criticism also applies to the largely comparable liability definition and other financial statement elements definitions in the IASB Framework (FW.60). For example, according to FW.70 (a) income arises from inflows or increases of assets or decreases of liabilities. However, only some increases of assets, such as increases in the fair value of certain financial instruments (IAS 39.55(a)) and biological assets(IAS 41.26), give rise to income, while others, such as increases in the fair value of available-for-sale financial assets (IAS 39.55(b)) and increases in the carrying amount of property, plant and equipment (IAS 16.39) and intangible assets (IAS38.85) resulting from a revaluation, are credited directly to equity and thus do not give rise to income. The fact that the IASB has more or less arbitrarily drawn the line between unrealized increases in assets that are recognized through profit and loss and unrealized asset increases excluded from income (IASB, 2005a, p. 11) reveals that the income definition in the IASB Framework is too broad to limit (arbitrary) choices in the development of accounting policies, either by the Board or by preparers.

The same can be said about the general recognition criteria in the IASB Framework, the probable inflow of future economic benefits associated with an item and its reliable measurement (FW.83). The IASB Framework does not provide any thresh-old that must be met for the inflow of economic benefits to be regarded as probable. In view of the vagueness of the probability criterion, it is not surprising that the IASB has set different probability requirements for different accounting issues, as evidenced below for the recognition of revenue from the sale of goods and construction contracts. As regards the reliable measurement criterion, the IASB (2005a) has observed that the 'accounting standards have different (inconsistent?) hurdles for sufficiently reliable measurement and different (inconsistent?) treatments for insufficiently reliable measurement' (p. 11). It follows that the general recognition criteria in the IASB Framework do not provide a suitable basis for the consistent deduction of accounting policies in the absence of an IFRS.

Instead of providing guidance on how to find an appropriate measurement attribute in a specific situation, the IASB Framework only lists several measurement bases that are used in the accounting practice (FW.100) (IASB, 2005d, p. 20). Due to the 'lack of an agreed, coherent measurement theory', inconsistencies in the measurement of financial statement elements exist in several IFRS, such as in IAS 39, which is deemed to 'reflect more or less arbitrary mixed measurement compromises spending resolution of conflicting views on appropriate measurement bases' (IASB,2005d, p. 20).This suggests that the required reference to the Framework's measurement concepts in the absence of an IFRS dealing with a specific issue or with related issues does not adequately guide managers' judgment in the choice of a measurement attribute.

STANDARDS AND INTERPRETATIONS DEALING WITH SIMILAR AND RELATED ISSUES

Since the IASB has not applied the IASB Framework's general recognition and measurement principles consistently to similar issues, some IFRS are inconsistent. For example, revenue from the sale of goods shall not be recognized until the seller has transferred the significant risks and rewards of ownership to the buyer (IAS18.14 (a)). This typically occurs with the transfer of legal title or the passing of possession to the buyer (IAS 18.15). If the 'risks and rewards criterion' were also to be applied to construction contracts, revenue would generally have to be recognized when construction is complete. It has been argued that in the case of long-term construction contracts, the 'completed contract method' would not appropriately reflect the enterprise's performance during the periods of construction (Paton and Littleton, 1940: 1965, p. 50; IFRIC, 2006, p. 4). Therefore, the IASB makes an exception from the risks and rewards criterion in the case of construction contracts. If the outcome of the contract is reliably measurable IAS 11.22 requires revenue from construction contracts to be recognized according to the stage of completion of contract activity at each balance sheet date, even if the enterprise has not yet transferred legal title or possession to the customer.

THE IASB'S EFFORTS TOWARDS THE ELIMINATION OF INCONSISTENCIES

Having recognized that the objectives, concepts and principles in the existing IASB Framework are partly ambiguous and internally inconsistent, the IASB and the FASB began a joint project on the revision and convergence of their conceptual frameworks in 2004. The objective of the project is to develop a common conceptual framework that is 'sound, comprehensive, and internally consistent' and thus constitutes an adequate foundation for the development of consistent, principles-based accounting standards (Bullen and Crook, 2005, p. 1; IASB, 2008, P4). This project is expected to last for many years.

One measure that the Boards plan to undertake in respect of the existence of conflicting objectives and accounting theories is to place greater emphasis on providing information on an enterprise's financial position and thus the assets/liabilities view (Dichev 2008, p. 458; Whittington, 2008, pp. 149–50). According to chapter 1 of the Exposure Draft of an improved Conceptual Framework for Financial Reporting the objective of financial statements shall 'only' be to 'provide information about the liabilities and equity)', that is, its financial position (IASB, 2008, OB6). The draft conceptual framework further states that information about an entity's financial performance is also essential (IASB, 2008, OB18, OB22). However, since the term 'performance' is planned to be defined in terms of changes in the entity's financial position, it appears as if the depiction of an enterprise's performance in the original sense (e.g., according to Paton and Littleton, 1940: 1965) shall no longer be a distinct objective of IFRS financial statements, from which consequential recognition and measurement criteria (such as the stage-of-completion method in IAS 11) are developed (similarly Bonham et al., 2009, p. 141).

Apart from this, the Boards intend to replace the term 'reliability' with the term 'faithful representation' in order to clarify its meaning (IASB, 2008, QC16, BC2.12–BC2.15).While this replacement is only supposed to be a clarification, some argue that the change in the wording also brings about a change in the meaning (Whittington, 2008, p. 146–7; see also Walton, 2006, p. 340; Lennard, 2007, paras 3.22–3.23). The currently required trade-off between relevance and reliability shall be substituted by a flow process (IASB, 2005b, paras 3–4), in which the standard setter or, in the absence of an IFRS, managers should first identify the economic phenomena that are relevant in making economic decisions and then choose the recognition and measurement methods the application of which provides the most relevant information (IASB, 2005c, paras 9–22, 2008, QC12) and then assess whether the chosen accounting method is a sufficiently faithful representation of the respective economic phenomena (IASB, 2008, QC13). Apparently, the draft conceptual framework prioritizes 'relevance' over 'faithful representation' (Whittington, 2008, p. 146; Gebhardt and Dean, 2008, p. 222). That is because one will have to choose the most relevant accounting method if the representation of the item is sufficiently faithful, even if there are other (less) relevant methods that would more faithfully represent the item.

In order to remove existing measurement inconsistencies the IASB is currently undertaking a project on measurement objectives. In line with the SEC's notion that the adoption of principles-based standards will probably lead to an increasing employment of fair value (SEC, 2003, III.I.i.) the IASB tentatively concluded that fair value is the most desirable measurement basis on initial recognition (IASB, 2005d, p. 13). In theory, the adoption of fair value as a single measurement attribute would lead to consistency since 'the fair value of any particular asset or liability is the same for every entity' (Barth, 2006, p. 275; see also Barlev and Haddad, 2007, p. 502; Barth, 2007, p. 11; Bromwich, 2007, p. 57). However, in practice the use of valuation methods in the absence of market prices which require managers to make estimates renders it most unlikely that companies calculate the same values in identical circumstances. This implies that internal consistency of accounting standards, for example as regards measurement, does not automatically guarantee a consistent application of the respective standards. Notably, Benston et al. (2006) argue that standard setters need to provide 'very detailed rules for calculating' fair values (p.173). The April 2009 changes to SFAS 157 Fair Value Measurements confirm this. It is, however, not in line with the current trend in standard setting to move from rules-based to more principles-based accounting standards on the one hand. On the other hand it also needs to be considered that providing rules does not automatically

create consistency. For example, IAS 39 provides extensive guidance on how to calculate fair values in the absence of market prices. Nevertheless, a consistent valuation of financial instruments is currently not achieved (Financial Stability Forum, 2008, pp. 28 et seq.).

CLARIFICATION OF THE MEANING OF 'RULES' AND 'PRINCIPLES'

The link is now made between the consistency issue and the rules-versus-principles debate in the accounting literature. The definitions and distinctive characteristics of rules and principles are identified based on the legal and accounting literatures. It is concluded that the removal of many deficiencies currently perceived in relation to the rules under U.S. GAAP and IFRS does not require a complete elimination of rules, but could also be achieved by a removal of present inconsistencies. Moreover it is demonstrated that a consistent application accounting standards does not only presuppose internal consistency of the accounting standards, but also the pro-vision of rules in the form of specific recognition and measurement requirements.

THE DEFINITION OF 'RULES' AND 'PRINCIPLES' IN THE ACCOUNTING LITERATURE

The accounting literature distinguishes between rules and principles by reference to their specificity and the degree of judgment that is required in their application: While the SEC, the Institute o Chartered Accountants of Scotland (ICAS) and most researchers characterize rule as being highly detailed and unambiguously prescribing specific accounting methods(SEC, 2003, I.D.; Kivi et al., 2004, p. 11; ICAS, 2006b, pp. 8, 10; see also Mason and Gibbins, 1991, p. 22), principles are typically described as broad guidelines that, instead of providing detailed implementation guidance, require preparers to exercise judgment in applying the principles to specific transactions and events (Tweedie,2002, 2005, pp. 33–4, 2007, p. 7; DiPiazza, Jr., 2008, p. 7; Tsakumis et al., 2009, pp. 6–7;see also SEC, 2003, para. I.C.; Psaros, 2007, p. 528).

Tweedie (2002, 2007, p.7) points out that in an accounting system that is based on principles only, many individual transactions and events are not explicitly dealt within any standard. In such cases, managers are supposed to select and apply appropriate accounting policies by exercising professional judgment. Dickey and Scanlon (2006) further note that in a principles-based system enforcing agencies are only allowed to second-guess managers' professional judgment if the selected accounting policies are not in conformity with the high-level principles or if the judgment was not made 'in good faith' (pp. 16–17; see also Ng, 2004, p. 20; Tweedie, 2007, p. 8; Bonham et al., 2009, p. 73). They conclude that 'the principles-based_ approach theoretically permits public companies to have differing accounting judgments within the framework of these broad principles' (Dickey and Scanlon, 2006, p. 13).

We hold that many of the problems related to rules under U.S. GAAP and IFRS, such as scope exceptions and excessive implementation guidance, do not require the elimination of all specific guidance as requested by some in the accounting literature. We argue that they may also be resolved by eliminating the inconsistencies within the respective accounting systems. For example, if IAS 39 would require measurement of all financial instruments by reference to a consistent measurement basis the standard would (automatically) contain much less specific guidance.

IMPACT OF THE LEVEL OF DETAIL OF ACCOUNTING STANDARDS ON CONSISTENCY IN THEIR APPLICATION

As shown above, principles-based standards may, even if internally consistent, be applied differently to identical issues by different companies and thus do not ensure consistency in the application of the accounting standards. That is because principles alone do not provide a sufficient structure to limit managers' judgments in the application of the principles to specific transactions and events. This means that if consistency as regards the application of accounting standards is strived for, rules, which are consistently developed on the basis of the high-level principles, need to be provided.

Foe exposition consider: A revenue recognition principle could be that revenue should be recognized when the inflow of economic benefits is probable. Since it depends on managers' judgment when the inflow of economic benefits is regarded as probable, it may happen that in the case of an identical sales contract one company recognizes revenue at contract conclusion while another company recognizes revenue with the receipt of cash. If consistency in the application of accounting standards shall be ensured consistent rules for different types of revenue-generating transactions need to be provided. A rule for the sale of goods could be that revenue shall be recognized when the good is handed over to the customer and no significant additional obligations remain to be fulfilled (more specific [consistent] guidance for additional obligations, such as warranties, may be provided). Since the risk that the sold product does not conform to the contractually agreed specifications is higher in construction contracts than in sales contracts a consistent revenue recognition rule for construction contracts would require the customer's acceptance of the finished product for revenue to be recognized.

2. DISCUSSION

The following loosens our previous assumption that a consistent application of accounting standards by all companies is required. The advantages and disadvantages of principles-based and rules-based accounting standards are examined, leading to the conclusion that, for reasons of comparability, enforceability and objectivity of financial reporting information, it is important to have specific (internally consistent) accounting requirements that limit managers' judgments in the application of accounting standards to ideally only one possible accounting method. It is acknowledged, however, that this may, in some situations, lead to an impaired relevance of financial reporting information.

RULES-BASED STANDARDS INCREASE THE COMPARABILITY OF FINANCIAL REPORTING INFORMATION

Raz (1972) and others consider rules to lead 'more easily to uniform and predictable application' and thus to create consistency and comparability (p. 841; McBarnet and Whelan, 1991, pp. 848–9; ICAS, 2006b, pp. 10–11). By contrast, principles, according to Dickey and Scanlon (2006), may be applied differently to identical cases across companies due to differences in the use of judgment thereby leading to a lack of comparability and consistency in the application of accounting standards (p. 13).

Its recourse by many over several decades suggests that comparability is a desirable characteristic of financial reporting: Especially in the U.S. accounting literature many authors, such as Schipper (2003), emphasize the need for comparability of financial statements (pp. 62–3). In the1960s discussion by the 'Golden Age' theorists, including Chambers (1966) and Moonitz (1961), comparability was a major postulate underpinning their ideas. Furthermore, it is demanded and much valued by investors (Choi and McCarthy, 2003, p. 7, referring to a letter issued by the Association for Investment Management and Research in 2000), it is one of the very reasons for the existence of accounting standards (Previts and Merino, 1998, pp. 228–34; Schipper, 2003, p. 62) and it underpins the EU's requirement for listed companies to apply uniform accounting standards in the form of IFRS in their consolidated accounts (Article1 IAS Regulation).

However, cross-firm comparability of financial statements, imply that a company showing high income at the end of the accounting period is economically better off than other companies with a lower income number, is not achievable, not even by means of uniform accounting standards. One reason noted by Alexander and Jermakowicz (2006) is that the application of specific rules may require economically different situations to be accounted for identically and thus create a pseudo-comparability (Alexander and Jermakowicz, 2006, p. 150).

PRINCIPLES-BASED ACCOUNTING STANDARDS INCREASE THE RELEVANCE OF FINANCIAL REPORTING INFORMATION

Apart from the creation of a 'pseudo-comparability' in some cases, rules are criticized for failing to capture the particularities of individual cases (Bratton, 2003, p.1037) and for allowing preparers to 'structure transactions round_ the prescriptions, thereby circumventing the intent and spirit of the standards' (Cunningham,2007, p. 11). Principles, by contrast, are regarded as being hardly susceptible to an evasion of their intended purpose (Broshko and Li, 2006, p.5) and, due to their flexibility and the required use of professional judgment, as having the capacity to give consideration to the particularities of individual cases (Bratton, 2003, p. 1037; Cunningham, 2007, p. 11).

Another reason why many, for example, Alexander and Jermakowicz (2006), argue that principles provide more relevant information than rules is that managers' best know the economic reality and how to account for it (p. 150). Others, for example, Bagnoli and Watts(2005), furthermore highlight the positive influence of the existence of implicit accounting choices on the relevance of financial reporting information by providing evidence that managers' accounting policy choices allow the market to infer managers' private information about the firm's economic situation ('signalling effect') (p.798).

However, downside of the flexibility of principles is, according to Beechy (2005), that managers may not always choose the most relevant accounting method since managers are always biased—even if they do not have fraudulent intentions (p.199). Guenther (2005) attributes this, amongst other things, to the pressure to present good results in the short term, especially when the personal income is bound to the achieved results (pp. 6, 12–13). Rentfro and Hooks (2004) additionally remark that the recent corporate scandals, such as the case of Enron, indicate anecdotally that managers do not always apply accounting standards

in good faith (p. 89; for the possibility of abuse of imprecise accounting standards see Clarke and Dean, 1992, 1993, 2007). Principles-based accounting standards are hence criticized for providing increased potential for earnings management (Beechy, 2005, pp. 199–200; Benston et al., 2006, p. 173).
In conformity with this, Ewert and Wagenhofer (2005) find that tighter accounting standards reduce earnings management. However, they also find evidence that tighter accounting standards increase real earnings management, that is, a change in the structure of transactions or events in order to avoid the consequences specified by an accounting standard.
Laux and Leuz (2009, pp. 830-1) provide an example that will illustrates the above stated conflict between the relevance of managers' flexibility and the risk of earnings management: Since the measurement of fair value by reference to market prices is—if contagion effects exist—not appropriate, managers must deviate from market prices and determine fair value by means of valuation models in order to provide relevant information. However, it is often not clear under which circum-stances market prices are misleading. Laux and Leuz conclude that 'managers have an information advantage over the gatekeeper (e.g., auditors or the SEC) and, as a result, it is difficult to write FVA standards that provide the flexibility when it is needed and constrain managers' behaviour when it is not needed' (p. 831).

RULES-BASED STANDARDS INCREASE THE ENFORCEABILITY OF FINANCIAL REPORTING STANDARDS

Since in the case of rules actors know without ambiguity what to do in order to obey rules, the advantage is seen to be in their contribution to certainty and enforceability (ICAS, 2006b, pp. 10–11). On the other hand principles, due to their vagueness, are regarded to be difficult to enforce and thus to create uncertainty (Cunningham, 2007, p. 11).
As stated above, in the case of principles-based standards enforcing agencies have to accept that there will be circumstances where managers of companies account for identical transactions differently. Consequently, the agencies shall only be allowed to second guess managers' professional judgments if the selected accounting policies are not in conformity with the high-level principles or if the judgments were not made 'in good faith'. But, since principles-based standards allow differing interpretations of the broad principles often it will be—especially in the absence of specific guidance—difficult to judge whether an adopted accounting policy conforms to the principles and whether the judgment was made in good faith (Kivi et al., 2004, p. 12).Some therefore doubt that regulators in litigious environments, such as the U.S., will be willing to accept different applications of the same principles (Taub, 2004).Dickey and Scanlon (2006) observe that in this case, preparers would be exposed to a higher risk of litigation because enforcing agencies may allege violation even if the required professional judgment was exerted in good faith (p. 16).

RULES-BASED STANDARDS INCREASE THE ENFORCEABILITY OF FINANCIAL REPORTING STANDARDS

In the accounting literature the quest for consistency as regards the application of accounting principles is mostly premised on the desire to achieve output comparability in the form of financial statements (see, e.g., Schipper, 2003, p. 62). Some believe that there is another equally important reason. Apart from providing decision-useful information, accounting is also frequently used for stewardship/contracting purposes, for instance its use in employment contracts and debt covenants, in order to calculate annual bonuses or to limit future debt levels (Watts and Zimmerman, 1986, p. 196).Those other functions—stewardship and accountability—have a long history (Edwards et al., 2009). Guenther (2005), for example, points out those accounting-based contracts only efficiently balance the interests of the contracting parties if there is agreement on how the relevant accounting numbers are calculated (pp. 5–8). As stated above, principles-based accounting standards some-times permit managers to choose between several different accounting methods. With regard to debt covenants, principles-based standards thus enable managers to circumvent covenant restrictions by (voluntarily) changing to a more favorable accounting method (Healy and Palepu, 1990, p. 97, referring to accounting choice sunder U.S. GAAP). Indeed, many researches, for example, Smith and Warner (1979), have provided sound empirical evidence that managers make use of this flexibility in order to avoid costly violations of the contract.
Watts and Zimmerman (1990) argued that flexibility in the choice of accounting policies increases costs and thus decreases contract efficiency (p. 135). That is because lenders either price-protect themselves against managers' 'creative accounting' or they restrict the number of available accounting methods by using fixed GAAP provisions, which are costly to negotiate and monitor for the lender and costly for the borrower because he needs to prepare an extra set of financial statements for contracting purposes. According to Leftwich (1983) another downside of vague principles from a contracting perspective of financial reporting is that they create uncertainty about the terms of the contract and increase the risk of litigation between the contracting parties (pp. 28–9).
From a contracting perspective of financial reporting, it is essential to restrict managers' judgment in the absence of clear guidance to only one possible accounting method. Principles-based accounting standards have been shown not to ensure this since they often permit managers to choose between different accounting methods. A purported advantage of rules-based accounting standards (not necessarily containing bright-line tests that allow managers to circumvent the rules' purpose)is that they provide clear guidance and, through this, limit managers' ability to influence the relevant accounting numbers. Anyhow, if the rules are not internally consistent, managers may, in the absence of concrete guidance, arbitrarily choose between several even opposing accounting policies. From a contracting perspective, specific accounting standards are therefore only effective if they are internally consistent.
It becomes obvious that when discussing whether rules or principles are favorable the possibility of a trade-off between relevance on the one hand and comparability, enforceability and objectivity on the other hand must be considered. The AAA FASC (p. 74) makes the point by providing an example similar to the following one: A rule prescribing that certain assets shall be depreciated over ten years would most probably be applied consistently by all companies, it would create comparability and it would be easily enforceable. However, the rule does not necessarily provide useful information because it fails to reflect the 'real' decline in the asset's economic value. A principle stating that all assets shall be depreciated according to the decline of their economic value in the respective accounting period may provide more relevant information, but it is unlikely that all companies would make identical estimates with regard to the 'real' economic value of a certain asset, that is, the principle would not be applied consistently to identical events by all companies. Furthermore, the estimation of an asset's economic value opens potential for earnings management and it is difficult to judge whether it was made in good faith and thus should not be second-guessed.

3. CONCLUSION AND SUGGESTIONS

For reasons of comparability, enforceability and objectivity it is particularly important to limit managers' judgments in the application of accounting standards to one possible accounting method and thus to provide for a cross-firm consistent application of accounting standards. According to that analysis, the present IFRS system fails, for a large part, to ensure this. That is because the inconsistencies between the objectives, qualitative characteristics and general recognition and measurement criteria in the IASB Framework as well as between the requirements and guidance in certain Standards and Interpretations permit managers to(sometimes arbitrarily) choose between different accounting policies in the absence of clear guidance. This led to the conclusion that consistency in the application of accounting standards requires at least consistency between the accounting standards themselves.
When exploring the differences of principles-based and rules-based accounting standards we found that internal consistency alone cannot sufficiently ensure a coherent application of accounting standards. That is because principles do not provide a sufficient structure to limit managers' judgment in the application of the principles to specific transactions and events. Thus, accounting systems should be based on principles, but should not consist of principles only. There should be a set of high-level principles from which more concrete accounting rules are consistently derived. Due to the consistency between rules addressing comparable issues managers' flexibility in applying accounting standards would be much more limited than under present U.S. GAAP and IFRS.
A normative analysis of the research question focuses on why consistency of accounting standards matters. Further research is required to test empirically or analytically whether internally consistent accounting rules limit managers' judgments in the application of accounting standards. Further research could work out how such a system could be put into practice and what the content of IFRS would have to be.
Finally, it is important to note that we developed our arguments for internal consistency in a normative way, agreeing with Alexander and Jermakowicz's (2006) objection that the 'absolute' consistency of all accounting principles is not achievable (p. 150). However, just as in the case of other ideals, such as justice, equality and freedom, the impossibility to achieve internal consistency in absolute terms, from a normative perspective, does not negate its desirability nor that it should sought.

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