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Principles- Versus Rules-Based Accounting Standards: The FASB's Standard Setting Strategy

In response to criticism of rules-based accounting standards and Section 108(d) of the Sarbanes-Oxley Act of 2002, the SEC proposed principles-based (or 'objectives-oriented') standards. We identify several shortcomings with this approach and focus on two of them. First, the format (type) of a standard is dependent on the contents of what the standard regulates. Given the asset/liability approach combined with fair values, we argue that the combination of this measurement concept with principles-based standards is inconsistent because it requires significant guidance for management judgment. Second, we propose the inclusion of a true-and-fair override as a necessary requirement for any format that is more than 'principles-only' to deal with inconsistencies between principles and guidance. We discuss the benefits of this override and present evidence from the United Kingdom's experience.

Key words: Accounting standards; FASB; Principles; Rules; Rules-based.

According to a widely-held view, U.S. accounting standards are more rules-based than principles-based.[1] This observation stems in large part from the emphasis put on two aspects of the wording of the typical attestation statement: 'the financial statements *present fairly*, in all material respects, the financial position of X Company as of Date, and the results of its operations and its cash flows for the year then ended *in conformity with generally accepted accounting principles* [*GAAP*]' (emphasis added).[2] 'Present fairly', which indicates a principles-based approach, is essentially converted to a rules-based approach when it is 'defined' in SAS 69

[1] The papers in this forum adopt varying positions regarding this view.

[2] The FASB's proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles* (FASB, 2005a), would more explicitly codify the rules. It says in para. A5 it expects to 'reduce the number of levels of accounting literature under the GAAP hierarchy to just two ('authoritative and non-authoritative . . . [and] integrate GAAP into a single authoritative codification'). The standards adopted by the FASB would be the first level.

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(.05 a) by reference to Rule 203 of the AICPA Code of Professional Conduct. This rule states that 'present fairly' 'implies that the application of officially established accounting principles almost always results in the fair presentation of financial position, results of operations, and cash flows'.[3] GAAP is specified by SAS 69, paragraph AU 411, as a hierarchy of conventions, rules and procedures promulgated by specified authoritative bodies, particularly the Financial Accounting Standards Board and predecessor organizations (e.g., the Accounting Principles Board).[4] Thus, if the enumerated and codified GAAP have been followed as specified, presumably the attesting CPAs have done their jobs correctly and adequately in the eyes of the Securities and Exchange Commission and (probably) the Public Company Accounting Oversight Board (PCAOB).

Largely because of the Enron Corporation failure, wherein Arthur Andersen was seen as designing or accepting client-originated financial instruments that met the technical requirements of GAAP while violating the intent,[5] the rules-based approach has come under fire.[6] As a direct result of the misleading accounting procedures revealed in the investigations of Enron's failure, the Sarbanes-Oxley Act of 2002 included a provision, Section 108(d), instructing the SEC to conduct an investigation into '[t]he Adoption by the United States Financial Reporting System of a Principles-Based Accounting System'. The SEC's Office of the Chief Accountant, Office of Economic Analysis, issued a 68-page Report (the 'Report') in July 2003 (SEC, 2003).[7] In July 2004, the FASB (2004) responded and in almost

[3] The AICPA's Auditing Standards Board proposed amendment to SAS 69 (AICPA Auditing Standards Board, 2005) includes this language. Although the statement includes an 'almost always' qualifier, it has not been interpreted to allow for an override.

[4] If adopted, SAS 69 applied to non-governmental entities would delete the GAAP hierarchy specified, particularly the statement in paragraph .05 a that gives as the first source—'Accounting principles promulgated by a body designated by the AICPA Council to establish such principles'—and .05 b which includes: 'Pronouncements of bodies composed of expert accountants, that deliberate accounting issues in public forums for the purpose of establishing accounting principles or describing existing accounting practices that are generally accepted'. These and other sources would be replaced by the FASB, which 'is responsible for identifying the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States' (AICPA Auditing Standards Board, 2005, .08).

[5] Andersen actually was charged by the Department of Justice with destroying evidence and was found guilty in a jury trial in June 2002 of 'witness tampering' because one of its lawyers had 'corruptly' persuaded Andersen employees to destroy documents in advance of an SEC investigation. In May 2005 the Supreme Court reversed that conviction, ruling 'that the jury instructions failed to convey properly the elements of a "corrup[t] persuas[ion]" conviction' (*Arthur Andersen LLP, Petitioner v. United States*, No. 04-368, 31 May 2005, Renquist, J., p. 1). The U.S. Department of Justice then chose not to pursue the case.

[6] Following a detailed description and analysis of Enron transactions audited or participated in by Andersen, the Examiner in Bankruptcy for Enron (Batson, 2004, Appendix B, p. 167) concludes: 'The evidence reviewed by the Examiner, and the reasonable inferences that may be drawn from that evidence, are sufficient for a fact-finder to conclude that Andersen was negligent in the provision of its professional services to Enron. In addition, the evidence is sufficient for a fact-finder to conclude that Andersen aided and abetted certain Enron officers in breaching their fiduciary duties to Enron.'

[7] Printed in what the web document describes as the 'smaller' text size.

all respects agreed with the SEC Report (in part, no doubt, because the Report agreed with an earlier FASB [2002] statement and recommended that the FASB be the sole U.S. standard setter).[8] Therefore, the Report, which summarizes much of the writing on this subject (including submissions by the FASB), provides a point of departure for an analysis of the 'rules vs principles' debate. Given this degree of unanimity and the reasonable presumption that the Commission approved the Report, its analyses and recommendations should be taken very seriously.

We begin our analysis by reviewing the SEC's (2003) Report that suggests a principles-based (or, as it calls it, an objectives-oriented) approach and the subsequent strategy of the FASB with respect to principles-based standard setting. Two major shortcomings are discussed in subsequent sections. First, the format of standards cannot be discussed and decided on without considering the contents of what the standard should prescribe. Observing that the FASB follows the asset/liability approach and increasingly adopts fair-value measurements, we argue that the combination of this measurement concept with principles-based standards is inconsistent. A major reason is that fair values require many rules to provide sufficient guidance, they invite manipulation, and they often cannot be assured by auditors.[9] We propose to move back from an asset/liability approach with fair values to the traditional revenue/expense model, which is better able to produce trustworthy and auditable numbers.

The second shortcoming is the dismissal of a true-and-fair override that we argue is a necessary requirement for any standard setting approach. The more rules the standards include, the more an override provision is necessary to avoid allowing or even requiring accountants to follow rules by letter but not by intention. The override gives accountants more professional responsibility for financial statement content, and its disclosure gives sufficient transparency for users to understand and, perhaps, challenge its application. We present evidence on the use of a true-and-fair override from the United Kingdom's experience and discuss how International Financial Reporting Standards (IFRSs) cope with the issue.

The format of accounting standards is not exclusively a U.S. issue, although the current debate has emerged there in the aftermath of accounting scandals, but is of international interest because the FASB and IASB have agreed to converge their standards as much as possible. Recent evidence of convergence is their June 2005 joint exposure draft on business combinations (FASB 2005b; IASB 2005a), which has even the same numbering of paragraphs.[10] Thus, the U.S. debate on

[8] Furthermore, the AICPA Auditing Standards Board (2005, p. 5), states that the FASB's (2005a) proposed statement, *The Hierarchy of Generally Accepted Accounting Principles*, is '[i]n response to recommendations in the [SEC's Report]'.

[9] It is interesting to note that when accounting standards (or principles) were controlled by accounting practitioners who served on AICPA committees, proposals for fair- and present-value restatements of assets were not taken seriously.

[10] However, the IASB draft includes less content, so that some paragraphs are 'not used' to preserve the consecutive numbering with the FASB draft.

principles vs rules should not be viewed solely from an U.S. perspective but, rather, from an international one.

THE REASONS FOR RULES-BASED STANDARDS

In October 2002 the FASB issued a Proposal, *Principles-Based Approach to U.S. Standard Setting*. The Proposal's introduction (FASB, 2002, pp. 2–3) explains: 'in the Board's view, much of the detail and complexity in accounting standards has been demand-driven, resulting from (1) exceptions to the principles in the standards and (2) the amount of interpretive and implementation guidance provided by the FASB and others for applying the standards'. According to the FASB, the exceptions resulted from the Board having to make compromises with presumably powerful interest groups that prevented it from implementing its desired principles. The Proposal makes particular mention of FAS 133, *Accounting for Derivative Instruments and Hedging Activities*, the complexities of which resulted from the Board having to make numerous exceptions from the general principles promulgated in FAS 133, para. 3. The extensive guidance, it says, results from having to fulfill the objectives of comparability and verifiability. The Proposal rejects 'principles-only' standards, because these 'could lead to situations in which professional judgments, made in good faith, result in different interpretations for similar transactions and events, raising concerns about comparability' (p. 9). Comparability may be seen as especially important in an international environment, as there is the danger that local accountants and regulators arrive at differing views on the interpretation of contentious accounting issues.

In addition, the FASB (and its predecessors) have developed rules-based standards to meet the demand of major constituents, particularly management and auditors, who want a clear answer to each and every perceivable accounting issue. The litigious situation in the United States (and increasingly in other countries) means that the risk of law suits based on alleged wrong accounting is high and gives accountants a strong incentive to ask for rules they can adhere to in case of a costly law suit. As Schipper (2003) points out, rules are likely to proliferate as accountants ask for guidance that, they hope, will protect them from criticism and lawsuits.

Detailed rules and authoritative guidance also serve standard setters' and regulators' objective of reducing the opportunities of managers to use judgments to manage earnings (and of auditors to have to accept that practice). Standard setters can be and must show that they are active standard setters. Thus, they may tend to overproduce standards and to write detailed rules covering almost any conceivable situation.

THE CASE FOR PRINCIPLES-BASED STANDARDS

Despite the demand for rules-based standards, the FASB (2002, 2004) and the SEC (2003) reject them and have turned to proponents of principles-based standards, presumably because in the light of the accounting scandals they consider the costs of rules-based standards to outweigh their benefits. The SEC Report states:

> Unfortunately, experience demonstrates that rules-based standards often provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of the standards. This can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events. In a rules-based system, financial reporting may well come to be seen as an act of compliance rather than an act of communication. Moreover, it can create a cycle of ever-increasing complexity, as financial engineering and implementation guidance vie to keep up with one another. (SEC, 2003, at note 13)[11]

For these reasons, and based on an example of how corporations (mis)used the 'bright lines' given in APB Opinion No. 16 that specify when a business combination could be accounted for with the pooling of interests method rather than the purchase method, the Report concludes that a rules-based system is not desirable.

Other critics of rules-based standards have pointed out that rules can become useless and, worse yet, dysfunctional when the economic environment changes or as managers create innovative transactions around them (Kershaw, 2005, pp. 596–7). Moreover, such standards need not reduce earnings management and increase the value relevance of financial reports in so far as the rules increase managers' ability to structure transactions that meet these rules while violating the intent (e.g., Nelson *et al.*, 2002) and real earnings management may overcompensate for judgmental discretion (see Ewert and Wagenhofer, 2005).

The Report therefore examines what it terms 'principles-only' standards, which it defines as 'high-level standards with little if any operational guidance' (at note 13). It then dismisses this alternative, since 'principles-only standards typically require preparers and auditors to exercise judgment in accounting for transactions and events without providing a sufficient structure to frame that judgment. The result of principles-only standards can be a significant loss of comparability among reporting entities' (at note 14).[12] The Report does not further consider whether or to what extent the financial statements of different entities can be more or less meaningfully compared even when based on common rules or principles.[13]

[11] The Report's page numbers differ depending on the format in which the electronic version is printed. Hence, we locate quoted material by the nearest footnote.

[12] The SEC Report (2003, at note 15) gives two numbered additional concerns that could be ascribed to principles-only standards: '(2) a greater difficulty in seeking remedies against "bad" actors either through enforcement or litigation, and (3) a concern by preparers and auditors that regulatory agencies might not accept "good faith" judgments'. These are not further discussed. However, in a section entitled 'The Role of Judgment in Applying Accounting Standards', the Report appears to dismiss (3), as it states: 'it is simply impossible to fully eliminate professional judgment in the application of accounting standards' (p. 15 at note 21). Nor would we wish to, as we discuss later.

[13] See Dye and Sunder (2001, p. 266) for cogent arguments pointing out the shortcomings of uniformity (the same rule, e.g., expense research and development, yields different results when one firm's activities are successful and another's efforts are a failure) and the benefits (reporting choice reveals strategies) from allowing financial statement preparers to choose among alternatives.

Rather, it offers only two related examples to explain its rejection of principles-only standards, impairment of long-lived assets and recording depreciable assets at their historical 'time of acquisition' cost. The Report criticizes the lack of implementation guidance, which leads to a loss of comparability. However, it does not recognize that, no matter how a long-lived asset is initially recorded, comparability is lost as soon as the asset is purchased, as its value in use differs among users. Over time, both value in use and value in exchange or replacement value also change and the alterations will differ among companies; furthermore, the changes often cannot be determined objectively. Consequently, comparability would only be possible if strict rules for revaluing assets at unambiguously specified values were used. It is not 'principles-only' that is at fault here, but the inevitable and, indeed, desirable lack of comparability due to different economic environments. Further, the Report does not recognize that a company's choice of accounting measurement or presentation can convey information that is valuable to investors about the managers' operational and investment approach and decisions.

The Report proposes, rather than 'principles-only', what it calls 'objectives-oriented' standards, which are said to be optimal as between principles-only and rules-based standards, apparently because they offer a much narrower framework that would limit the scope of professional judgment but allow more flexibility than rules-based standards. 'Objectives-oriented' standards are similar to what the FASB (2004) calls principles-based standards. They appear to be those where the accounting reflects the economic substance of the accounting problem and is consistent with and derived from a coherent conceptual framework, from which there are few exceptions. These standards, the Report asserts, should:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis ['Note 1 of the Report says: "In doing so, however, standard setters must avoid the temptation to provide too much detail (that is, avoid trying to answer virtually every possible questions within the standard itself) such that the detail obscures or overrides the objective underlying the standard." '];
- Minimize exceptions from the standard;
- Avoid use of percentage tests that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard. (SEC, 2003, p. 5 at note 1)

This is a sensible and desirable list of characteristics and admonitions. Indeed, it is a wish list to which all standard setters would subscribe. But it begs the question as to how much detail should be included in objectives-oriented standards. Indeed, the Report gives no indication of how such an 'objectives-oriented' standard should or can be derived.

The AAA Financial Accounting Standards Committee (2003) also uses the term 'concept-based' standards and attaches the following characteristics to them: an emphasis on the economic substance rather than the form of a transaction, a description of the particular transaction that is the subject of the standard, disclosure requirements, and some implementation guidance in the form of examples. The Committee says (p. 76): 'Concept-based standards have the potential to promote the financial goals of the FASB in ways that rules-based standards cannot . . . Concept-based standards reflect a more consistent application of the FASB's Conceptual Framework and enhance individuals' understanding of the framework.'[14]

We agree with the view that 'optimal' standards are somewhere in the continuum of 'principles-only' and 'rules-only'. In search of a universal, if not an optimal approach to standards, the FASB has been including more principles in their recent standards and exposure drafts (some examples are given below), while the IFRS has added significantly more guidance to their principles-based format in their recent standards (as shown from the increase from year to year in the number of pages of the printed version). In the following, we hypothesize two avenues to correct flaws in this search for improvement to U.S. standard setting: (a) recognizing that the format of standards is related to their contents and (b) a true-and-fair override in the standards.

CONTENTS AND FORMAT OF STANDARDS

An assessment of the format of standards, or their underlying philosophical bases, crucially depends on their regulatory content, that is, on the underlying accounting principles they are intended to observe. A major driver of complexity in accounting standards is the number of exceptions to a basic standard (FASB, 2002); another is the amount of judgment necessary to apply a standard, which then necessitates rules and guidance. To understand the SEC Report's objectives-oriented standards, it is important to consider its underlying accounting measurement or valuation model. We note that although the SEC has not sought to define or develop an accounting model, the close interdependence between the type of standard and its contents implies the need to outline such a model when it provides recommendations regarding the format for standards. While a standard seeks to implement a particular principle for an accounting problem, its drafters also should consider and try to avoid potential gaming by opportunistic company managers and accountants. Gaming specifically results from too much leeway given to management and accountants. In general, some principles provide more gaming opportunities than others. The more decision 'relevant' and the less 'reliable' a standard the more difficult it is to provide a standard that does not need significant guidance and rules.[15]

The Asset/Liability Accounting Model

The Report adopts the asset/liability model as the fundamental building block of accounting standards, and emphatically rejects the traditional revenue/expense

[14] The Committee also reviews a substantial body of academic research and finds it inconclusive.

[15] Bennett *et al.* (2005) provide a comparative analysis of the standards on research and development in the U.S., New Zealand and in IFRS.

model.[16] 'In the asset/liability view the standard setter, in establishing the accounting standard for a class of transactions would, first, attempt to define and specify the measurement for the assets and liabilities that arise from a class of transactions. The determination of income would then be based on changes in the assets and liabilities so defined.' In contrast, when describing the revenue/expense model, the Report states that it gives 'primacy to the direct measurement and recognition of the revenue and expenses related to the class of transactions. *Under this approach, the balance sheet becomes residual to the income statement, and contains assets, liabilities, and other accruals/deferrals needed to maintain a "balance sheet"*.' The Report rejects this approach: 'We believe that the revenue/expense view is inappropriate for use in standard-setting—particularly in an objectives-oriented regime'. One reason for this conclusion is that there 'are a variety of specific revenue recognition standards . . . for narrowly defined transactions or industries'. The other reason given for rejection of the revenue/expense approach is that it is necessary to measure wealth at the beginning and end of periods 'as a conceptual anchor to determining revenues and expenses that result from the flow of wealth during the period. Historical experience suggests that without this conceptual anchor the revenue/expense approach can become ad hoc and incoherent.'[17] The revenue/expense approach is blamed for the inclusion of deferred revenues and expenses that are incorrectly described as assets and liabilities. The Report concludes: 'Not surprisingly, an examination of these standards shows that various inconsistencies exist among the revenue recognition models'.[18]

However, similar, if not greater, problems arise with the asset/liability approach under principles-based standards. The reason is that the asset/liability approach cannot be applied consistently by accountants and managers without such extensive guidance that it would degenerate into providing rules-based standards. Although the Report does not clearly specify how assets and liabilities should be measured, since the economic definition of income is emphasized, it would appear that fair values should be used.[19] Indeed, the FASB (and the IASB) give priority to fair value measurements.[20] The FASB Exposure Draft on *Fair Value Measurements* (2005c, issued 2004 and revised 2005) is part of 'the Board's initiatives to simplify and codify the accounting literature, eliminating differences that have

16 The quotations in this paragraph are taken from the SEC (2003) between notes 72 and 78, emphasis in original.

17 No examples of or references to such historical experience are provided.

18 This statement is supported only by reference to FASB Project Updates, 'Revenue Recognition'. In fact, this document does not show or even mention inconsistencies.

19 See also the Report's observation that it is likely that the FASB will issue more standards with fair-value measurements (SEC, 2003, at note 100).

20 Evidence of the movement to fair value are the recent drafts with a full fair value approach for business combinations (FASB, 2005b, and IASB, 2005a) and the fair value option for financial instruments (FASB, 2006, and IAS 39, as revised June 2005), which is only the first part of a fair value project of the FASB (see Notice for Recipients of the FASB [2006] Exposure Draft). See also the discussion paper on measurement at initial recognition (IASB, 2005b).

added to the complexity in GAAP' (p. ii). A review of the FASB draft statement shows that extensive guidance is necessary to reduce the enormous room for judgment in determining fair values—and provides evidence for our conclusions.

Schipper (2003) additionally shows how, for example, application of a principle governing the fair value of financial instruments presents several difficulties. She lists and examines the definition of the term 'financial instruments', the value attribute (exit or settlement amount, entry value, net realizable value, value in use, deprival value), measurement of the value (e.g., bid, ask or midpoint, block discount, model or present value calculation), and the problem of how sparse trades and block trades should be handled. Exceptions to the standards can be dealt with, she says, only by means of rules, which 'add to the length and complexity of the standard, and lead to requests for explanations of the breadth of the exceptions' (p. 67). Except for assets and liabilities for which relevant and reliable market prices (on the 'relevant market') can be obtained, the values assigned must be determined from appraisals, present value calculations, or by reference presumably to similar assets.[21] It is likely that these numbers often are both costly to determine and subject to possible opportunistic manipulation by managers, if they can be calculated at all, considering the difficulty or impossibility of determining and measuring intra-firm externalities. Thus, if trustworthy numbers are useful to investors, very detailed rules for calculating them would have to be written by the standard setters. This clearly is contrary to the characteristics of the coherent conceptual framework specified by the Report, particularly its admonition against excessive detail (SEC, 2003, footnote 1).

A cogent example, discussed by Schipper, is changes that impair the value of recorded goodwill. The necessity of revaluing the assets gives rise to a series of questions that complicate application of the standards and require a significant amount of rules and guidance. Schipper (2003, pp. 64–5) asks:

> at what level in the organization should goodwill be tested for impairment, and how often? Since goodwill cannot be separately measured, how should the impairment test be carried out? If goodwill is found to be impaired, how should it be remeasured? The standard setting issue: How many of these questions should be answered in the standard and at what level of detail?

Besides the difficulties of measuring fair values, the measurement principle covers (at least currently) only a subset of balance sheet assets and liabilities. The SEC Report talks about specifying the measurement for a 'class of transactions' (2003 at note 72). This appears to be those that involve assets and liabilities that are economically similar, which, thus, defines the 'scope' covered by a standard. The Report would have the standard setter identify the assets and liabilities that are created, eliminated or changed by a transaction or event such that it is not too narrow or too broad—deemed 'optimal scope theory'. This implies a need for detailed rules that define 'narrow' and 'broad' and how recognizable classes of

[21] Some of the complexities of deriving values from models and other measurement issues are described, rather naively and uncritically, in the FASB exposure draft. For a critical assessment see Benston (2006).

transactions that can be distinguished from other classes. The Report gives an example to illustrate this 'theory'. The FAS 141 definition of business combinations is described as 'near the optimum point on the [objectives-oriented] continuum': 'A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests in one or more other entities and obtains control over that entity or entities' (SEC 2003 at note 86). Thus, there must be control for there to be consolidation; hence, it is not necessary for the standard explicitly to exclude equity-method investments. We find it difficult to see how this illustration helps one understand what the Report means by 'optimal scope theory'. The Report does not address whether an objectives-oriented standard could avoid a bright-line definition of control (e.g., one share more than 50 per cent, as specified in footnote 5 to FAS 141), even though the Report keeps saying it wants to do away with bright lines. Perhaps, an objectives-oriented standard would give considerably more weight to the final phrase of footnote 5, 'although control may exist in other circumstances'. Here, a bright line would serve only as an indicator to judge the existence of control.

A further implication of measurement for a class of transactions is that it generates the problem of adding the estimated market values of the acquired assets and liabilities with the historical book values of the acquirer's assets and liabilities. What does the sum of these numbers mean in terms of a general principle of 'representational faithfulness to economic substance'?[22] Although this concern with economic substance would seem to imply measuring assets and liabilities at their fair values and (presuming zero inflation) net income as the difference between fair values of net assets at the beginning and end of a period, adjusted for distributions and additional equity investments, the Report does not explicitly call for revaluation of *all* assets and liabilities at the end of an accounting period.

Revenue/Expense Approach

Although the asset/liability approach is consistent with the FASB's relatively recent pronouncements, it is inconsistent with its December 1984 Concept Statement No. 5 (*Recognition and Measurement in Financial Statements of Business Enterprises*), which describes well the traditional accounting model and declares (pp. 5–6):

- A statement of financial position does not purport to show the value of a business enterprise but, together with other financial statements and information, should provide information that is useful to those who desire to make their own estimates of the enterprise's value . . .
- Earnings is a measure of entity performance during a period. It measures the extent to which assets inflows (revenue and gains) associated with cash-to-cash cycles substantially completed during the period exceed asset outflows (expenses and losses) associated, directly or indirectly, with the same cycles.

[22] Indeed, the former G4+1 (a group of standard setters comprising of representatives of the International Accounting Standards Committee, Australia, Canada, New Zealand, the U.K. and the U.S.A; now disbanded) pondered the application of a fresh-start method that would require valuation of the acquiree's and acquirer's assets and liabilities at fair value (although only for a uniting of interest transaction).

We believe financial statements should be based on that traditional revenue/expense model and not the asset/liability model, for several reasons that we discuss at length elsewhere (Benston *et al.* 2006, ch. 2). In our view, the debate about accounting models is unlikely to be solved by analytical methods and that empirical evidence, if available, is unlikely to resolve the issue.

In brief, the revenue/expense model offers several essential benefits. One is that it has developed over many years on the basis of market experience, long before accounting standards were appropriated and became the responsibility and virtual monopoly of well-funded, professionally staffed (rather than practitioner dominated) quasi-governmental bodies, particularly the FASB. In fact, historically, at times when financial-statement preparers reported assets and liabilities at estimated 'fair' values, scandals ensued as the following examples show. In the 1870s, Germany experienced many scandals involving overvaluing of assets and the distribution of booked gains; as a reaction, in 1884 the law introduced a lower-of-cost-or-market rule to the earlier common current value measurement (see Schröer, 1993) and the balance-sheet oriented asset/liability approach was (partially) replaced by the revenue/expense approach. In the United States, before accounting reporting was regulated, some corporations included the estimated values of intangibles as assets. As shown by Ely and Waymire (1999) using data from 1927, the price of the shares of corporations that reported high values for intangibles were discounted relative to corporations that did not capitalize intangibles. The SEC's early refusal to allow any reporting other than numbers based on historical cost, particularly write-ups of assets and goodwill, apparently as a result of perceived inflation of assets by companies in the 1920s is another example (Walker, 1992; Rappaport, 1972, pp. 3–27, 7–10). Enron's use of fair value accounting, based on present value and other 'mark to model' estimates rather than on actual relevant and verifiable market prices, to inflate its asset values and income derived from the revaluation of assets to fair value provides a more recent example (Benston, 2006).

The model also utilizes the great benefit of double entry bookkeeping, by tying the numbers reported essentially to the results of actual market transactions (Ijiri, 1971). Although accruals that are necessary to assign and match revenue and expense to time periods require judgment and rules, errors and misestimates are quickly self-correcting or are otherwise limited. In addition, the revenue/expense approach avoids the exogenous volatility of market values that have no bearing on the financial performance or position of a going concern, which holds and uses assets for a longer term and consequently cannot avail itself of an opportunity to sell the assets at fair value.

Another benefit offered by the revenue/expense model is that, unlike the asset/liability model, it does not depend on periodic measurements of the fair values of assets and liabilities, particularly those that must be estimated because there are no reliable and verifiable market prices on which to base the values. Such estimates necessarily increase managers' discretion to choose amounts that fulfill their own objectives, such as inflating reported earnings and hiding poor operating performance. Because these essentially subjective judgments rarely can be audited effectively, the audit as a reliable procedure will be devalued. We are concerned that the possibilities for error and opportunistic manipulation of fair values by managers under the asset/liability approach may be so great that many important numbers reported in financial statements will become so untrustworthy as to make the statements of limited value to shareholders and potential investors. Furthermore, as standard setters seek to constrain misuse of fair value estimation, they will be forced to enact more and more detailed constraints and rules, thereby rendering nugatory principles-based or objectives-oriented standards.

To sum up, the Report's proposed objectives-oriented standards that would implement the asset/liability approach, which, particularly when combined with fair values, are inconsistent with its rejection of rules-based standards as they would require extensive and detailed rules. Although, as Schipper (2003, 67–8) points out, it will be difficult to show empirically whether the benefits are greater than the costs, we believe that both past and recent experience and simple logic make it likely that the costs of the asset/liability approach are likely to exceed its benefits, both to accountants and investors. In contrast, the revenue/expense approach is based on procedures that arise from long and tested experience; it has survived and flourished for a long time and should not be lightly abandoned.

TRUE-AND-FAIR OVERRIDE

Regardless of the model adopted, the SEC Report's rejection of the true-and-fair override is an important shortcoming, considering its strong condemnation of rules-based standards and rejection of a principles-only based standard. The override would allow—indeed, require—companies and attesting auditors to not follow a standard or rule if its application would result in the financial statements not presenting a true and fair view of the company's financial position, results of operations, and cash flows. The Report says (SEC, 2003, after note 95), 'we believe that when the standard setter establishes standards 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'.[23]

Currently, there exists an override in AICPA's Rule 203, which allows members to state that financial statements that contain a departure from GAAP are in conformity with GAAP if, due to unusual circumstances, the statements otherwise would be misleading. However, it is not embodied in the accounting standards and has virtually never been used in practice (see Zeff, 1995). The FASB recently issued an exposure draft (FASB, 2005a), which if adopted would explicitly eliminate an override to codified GAAP because it believes

> that the selection of accounting principles in accordance with the GAAP hierarchy results in relevant and reliable financial information. Therefore, an enterprise cannot represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in the Statement and that departure has a material impact on its financial statements. (FASB 2005a, para. A10)

[23] The Report makes no attempt to justify this assertion.

The SEC Report implies that objectives-oriented standards can portray economic arrangements in a way that omits nothing of relevance to investors, creditors and other users, and can specify and effectively deal with how these should be accounted for. However, the history of rules-based standards suggests that this is an 'impossible dream'. When companies and auditors seek guidance about how they are to account for a transaction that was not considered by the standard setter, new rules will be established. This then gives opportunistic managers a means of producing misleading financial statements that conform to the guidance and, hence, to GAAP. As Weil (2002) puts it, managers would continue to say to auditors, 'Show me where it says I can't'. A good example is Enron's misuse of the commonly understood definition of a 'business' to declare that its acquisition of two different assets (an airplane lease and a security) from a single seller constituted a 'business', so that it could record and use negative goodwill, pursuant to APB 16. Until EITF (Emerging Issues Task Force) 98-3, para. 6, specifically defined a 'business' as 'a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors', Enron could claim and Andersen concurred that calling the simultaneous purchase of two very different assets was a 'business' because there was no rule to say that it wasn't.

The need for a true-and-fair override results from the fact that principles in principles-based standards are principles on a number of very different levels and standards cannot be crafted so that they can exclude contradictions among them.[24] In such a case the hierarchy of principles must be clear as to which principles are stronger than others. Indeed, we can imagine that only the following principles-only standard would not need an override provision: 'Financial statements should give a true and fair view'. Of course, such a standard would not be implementable, if only because true and fair cannot be defined in a sufficiently operational way. An override would seem necessary to allow firms to follow those standards which reflect their economic situation where such conflicts arise. It is also necessary where following a specific standard which otherwise would be binding on the business does not reflect the economics of the situation. Finally, it is required where GAAP does not allow firms to show their economic position. Therefore, a true-and-fair override is necessary in any format of standards, but it is particularly important for a rules-dominated system, such as that currently adopted by the United States. The more rules, the more an override is required to allow for special adaptation. This is because rules-based standards deal with specific settings and are defined in detail, the need for recourse to an override to reflect the underlying economic structure of the business is more likely to be needed than with principles-based standards that allow the use of a variety of methods providing that they produce results consistent with the principle(s) of the standard. Moreover, with rules-based standards, a true-and-fair-view requirement may be a

[24] Nobes (2005) argues that a major problem has been inadequate application of or failure to use 'appropriate' principles by the FASB and IASB, and provides a discussion of six topics to illustrate his contention; see also Bromwich (1980).

better way to stop management from exploiting rules than trying to write further rules that seek to prohibit such conduct.

A necessary requirement for an override is disclosure of its reasons and effects. Its use, we believe, would improve the quality of financial statements by indicating the economic situation of the business and help to return to auditors both the opportunity and responsibility to use their professional judgments as to whether the financial reports of a company they audited actually fairly represent its financial condition, operations, and cash flows.[25] They could refuse the override, if they did not believe this was the case. Were a true-and-fair override both permitted and acceptable, CEOs and CFOs would be unable to claim that they were not required to follow the intent as well as the letter of GAAP or, indeed, that they had to follow the rules specified by GAAP because neither they nor their auditors had the authority to override those rules to give a true and fair view. In a sense, the possibility for an override shifts the burden of proof of what is a true and fair view from the user or regulator to the accountant.

In a recent exposure draft, *Proposed Statement of Financial Accounting Standards* '*Business Combinations*', the FASB (2005b) adopted the IASB's 'bold print' identification of principles (versus guidance) in standards. This identification reveals that 'principles' can be relatively specific and, thus, low in the hierarchy, and even include exceptions from *the* 'principle'. For example, the exposure draft (FASB, 2005b, para. 28) reads:

> The acquirer shall measure and recognize as of the acquisition date the assets acquired and liabilities assumed as part of the business combination. Except as provided in paragraphs 42–51, the identifiable assets acquired and liabilities assumed shall be measured at fair value and recognized separately from goodwill.

Then, there follow pages of guidance. Without a true-and-fair override it is hard to believe that such 'principles' can always result in relevant and reliable financial information. According to Bush (2005) the U.S. has had difficulty allowing for a true-and-fair override because it has no clear clause, embodied in the law, that could serve as a basis for an override of GAAP. A partial alternative to a true-and-fair override is a differentiation of guidance according to its authoritativeness, although this seems to be something which FASB is turning away from (FASB, 2005a). For example, U.S. GAAP currently includes authoritative guidance that addresses many specific issues that may arise when applying a standard in practice and it includes non-authoritative literature on various levels of the GAAP hierarchy. Deviation from non-authoritative guidance is possible, although it is unclear to what extent it must be made transparent in the financial statements. IFRSs distinguish between bold-face printed 'principles', application guidance and IFRIC (International Financial Reporting Interpretations Committee) interpretations, although all of them are equally mandatory. Much guidance could be relegated to non-authoritative literature. For example, in Germany the

[25] In an equilibrium model, Ewert (1999) shows that (vague) principles-based standards result in a preferable quality of financial statements relative to rules-based standards precisely because they place some risk on the part of the auditor.

accounting law is really based on principles and provides no guidance, and the standard setter's output has only the presumption of GAAP; additionally, a substantial commentary literature that fills in the gap of insufficient guidance has developed. In the United Kingdom, as more rules have been adopted, an override has become more necessary, if for no other reason than to operationally resolve conflicts between existing laws and some rules.

U.K. Experience With a True-and-Fair Override

Some might argue that allowing for a true-and-fair override is fraught with danger because some degree of comparability will be lost when accountants can choose when to depart from standards. The result, the fear, is that there could be chaos. The experience of the United Kingdom, which has had a true-and-fair override for a long time,[26] and the IASB, whose override is much younger and more restrictive than that of the United Kingdom, should be instructive.[27]

In the United Kingdom the dominant duty of management with respect to the financial reports is that '[T]he balance sheet shall give a true and fair view of the affairs of the company as at the end of the financial year; and the profit and loss account shall give a true and fair view of the profit and loss of the company for the financial year' (Sec. 226(2) of the Companies Act 1985). Failure to comply with that requirement would give grounds for accusations of negligence, thereby subjecting accountants and auditors to charges of professional misconduct, and the necessity of rewriting accounting reports. 'True and fair' is deliberately not defined as it is perceived to be a dynamic concept having a technical meaning distinct from its natural meaning (see Hoffman and Arden, 1983).[28] In the end it is a court's responsibility to decide what is necessary to give a true and fair view, but it is the management's responsibility to provide a true and fair view and for the auditors to agree or disagree. The Act provides that giving additional information might be sufficient to remedy any defect in the giving of a true and fair view, but in special circumstances the override must be invoked with full information about the departure, the reasons for it, and its effect.[29] U.K. Financial Reporting Standard (FRS) 18, *Accounting Policies* (ASB, 2000), specifies that these remedies should be used sequentially.

U.K. accounting standards have been strongly principles-based but do, of course, have to incorporate rules to provide a structure to the standards, although some recent standards are more rules-based, especially those involving financial

[26] Its occurrence dates back to the U.K. Joint Stock Companies Act 1844. Chambers and Wolnizer (1991) provide evidence for its use in practice even before that time.

[27] Other countries, including Australia, New Zealand, Spain and the Netherlands, also have a true-and-fair override, based largely on the U.K. provision.

[28] Some commentators (e.g., Walton, 1993, p. 49) opine that 'no one knows what it [the true and fair view] means'. See also other articles in the *European Accounting Review*—1993 (Vol. 2, No. 1) and 1997 (Vol. 6, No. 4). Others, such as Chambers and Wolnizer (1991), dispute that view.

[29] Kershaw (2005, pp. 611–14) argues that the U.K. situation is very similar to that of the United States.

instruments, reflecting a wish of the U.K. Accounting Standards Board, the U.K. independent standard setter, to converge their standards with those of IASB and the FASB. An indication of the effect of the principles-based approach of U.K. GAAP is the fact that at the end of 1999 all extant U.K. accounting standards were printed on 900 pages. The increased detail of recent standards is clear. The output of the Accounting Standards Committee (the predecessor of the ASB, 1970–90) accounted for only 239 pages whereas FRS 13 on derivatives and other instruments (issued by the ASB in 1998) on its own comprised 91 pages. A more telling contrast is with the FASB's Statements of Financial Accounting Standards through No. 140 (September 2000, the last year for which FASB statements were printed) which took up 2240 pages (FASB 2003/2004). It also is useful to compare the current FASB-drafted statements of accounting standards with the bulletins issued by its predecessor AICPA Committee on Accounting Procedures (CAP) from September 1939 through January 1953, compiled in the fifty-six page *Accounting Research Bulletin* 43. In addition, although the U.K. Urgent Issues Task Force (UITF) issues interpretations, unlike those issued by the U.S. EITF, they are small in scope, generally address detailed items and do not seek to be comprehensive.

The Accounting Standards Board's conceptual framework is entitled *Statement of Principles for Financial Reporting* (ASB, 1999). One of the objectives of the Statement is 'to help preparers and auditors faced with new or emerging issues to carry out an initial analysis of the issues involved in the absence of applicable accounting standards' (para. 4). The Statement makes it clear that professional judgment should be exercised. Such judgment is meant to respect the spirit of accounting standards, rather than just follow their form. Under U.K. law, such uses of judgment are also reinforced by the requirement to give a true and fair view of the company's affairs.

Use of the override will be limited under IFRS to those countries where the use of the override is permitted by domestic law. This generated a strong statement from the U.K. Financial Reporting Council (FRC, the umbrella body for accounting and audit regulators) saying that the giving of a true and fair view 'remains a cornerstone of financial reporting and auditing in the UK and professional judgment will continue to be central to the preparation and audit of financial statements' (FRC, 2005, p. 1). The FRC also believes that the U.K. requirements and those under IFRS are substantively the same, and stresses that the non-technical use of the override is small (FRC, 2005, p. 4).

Professional and legal opinion agrees that following accounting standards is necessary to give a true and fair view (see Hoffman and Arden, 1983, and Arden, 1997, for the EU context), but this opinion has not been tested in the courts. The freedom to override is restricted by a number of constraints, including the need to receive external-auditor approval for any override, the wish of those contracting with the company to lay down the accounting methods used by the firm (at least for contracting purposes), the likelihood that the court and the regulators would generally find the Companies Act and accounting standards persuasive and would appeal to current professional practice and that of the relevant industry in considering the application of the override, and concern that the use of the override might cause adverse publicity.[30] Overcoming these restrictions could be burdensome for the company seeking to use the override. Moreover, given the flexibility provided in the United Kingdom's essentially principles-based standards for the proper exercise of professional judgment, the need for recourse to the override is substantially limited. Consequently, true-and-fair overrides have been used rarely in the past. Their use has increased recently, mainly to allow companies to use accounting procedures laid down in standards that otherwise would be inconsistent with the Companies Act. The general picture is given by Livne and McNichols (2004) for the period 1998 to 2002 and by studies in a regular commentary called Company Reporting that give figures for 1997, 2000 and 2002.[31] These studies consider not only explicit use of overrides but also accountings that 'look like' overrides. Company Reporting indicates that the frequency of overrides by listed companies was 15 per cent in 1997 (536 companies), 20 per cent in 2000 (427 companies) and 25 per cent in 2002 (337 companies). The vast majority of the overrides (73 per cent of those found by Livne and McNichols) are 'mechanical', in the sense they were necessary to allow specific U.K. accounting standards to be followed even though they conflict with the requirements of the Companies Act.[32] Thus, use of the true-and-fair override is generally the U.K. method for overcoming the problem where outdated law would otherwise restrict the development of accounting standards.[33] The need for this use of the override will be substantially reduced in the future as the Companies Act has been amended by regulation (effective for the financial year commencing on or after 1 January 2005) to remove inconsistencies between the Act and IFRS, which also removes inconsistencies between the Act and U.K. standards. Thus, the use of the override for other purposes is relatively small (well under 10 per cent of U.K. listed companies with the above data) as we would expect with a principles-based regime but does involve a significant number of companies. U.S. data are, of course, not available to test the remaining part of

30 This view has been confirmed by a legal opinion sought by the Financial Reporting Council (the U.K. accounting and auditing regulator) from the solicitors Freshfields Bruckhaus Deringer, who also make the point that in adopting international accounting standards the EU Commission must ensure that the annual accounts and the consolidated accounts give a true and fair view (see http://www.frc.org.uk/frrp/press/pub0826.html from 24 June 2005).

31 For example, Company Reporting, May 2005, *Issue of the Month*, 'True and Fair Override' (see http://www.companyreporting.com). More details are provided in an area restricted to members only.

32 There were two major reasons for these overrides. One is non-depreciation of investment properties, which is required to follow the relevant U.K. accounting standard (SSAP 19, *Accounting for Investment Properties*) issued by the predecessor body to the ASB. This is in contradiction to the Companies Act requirement for all fixed assets to be depreciated/amortized. The other is necessary to allow firms to take up the option offered by the standard on goodwill, FRS 10, *Goodwill and Intangible Assets*, to not amortize purchased goodwill in the face of the Company Act's depreciation/amortization requirement (although strictly the override is available only to companies).

33 See Evans (2003) for a review of the literature that takes a legal perspective on the true-and-fair override.

our hypothesis—that the need for an override increases as accounting regimes become more rule intensive.

The Financial Reporting Review Panel (FRRP, established 1990) plays an important role in policing the use of the true and fair view in the United Kingdom. Inspection of its findings in the eighty-one cases up to and including 2002 yields a number of impressions.[34] First, about 20–30 per cent of the companies coming before the Panel relied on the true-and-fair override in their defense. Second, the Panel seems very concerned to rely on only the requirements of the Companies Act and relevant accounting standard(s) in determining its findings. This approach may be sensible for a relatively new body now also charged with carrying out an annual survey of accounting reports. It is also fair to say that the cases for using the override are often not compelling. However, these cases were prompted by complaints to the FRRP and may not indicate the strength of the other cases. Almost universally, the Panel has not accepted arguments based on the true-and-fair override. This suggests that the Panel so far has not encouraged innovative accounting going beyond the rules of GAAP. The one case where this defense was allowed involved the rather arcane subject of negative goodwill.[35]

Thus, if we consider only the cases coming before the FRRP, the true-and-fair override does not seem to have generated a large number of innovative treatments that seek to override the Companies Act or the accounting standards. The FRRP's recent more proactive searches for defective accounting reports may bring to light more examples where compelling evidence requires allowing resort to the true-and-fair override. Further evidence of the real extent of the use of the override may be generated as firms switch from U.K. accounting standards to IFRSs.

Livne and McNichols (2004) find that U.K. firms that override a GAAP rule (some 19 per cent of their sample), the strongest type of override, report poorer economic performance than control firms that do not use an override and suggest that this is consistent with an opportunistic use of the override, as most overrides tend to increase reported performance. They also find that the capital market appears to adjust the book-to-market and price-earnings ratios for the effect of an override in some cases, but that the financial reports of override firms are not less informative than those of the control group. On the other hand, use of the true-and-fair override has allowed accounting to respond to current conditions and has not led to anarchy in accounting, as many fear. An example of this is where using the override allowed companies to anticipate later requirements of FASB and IASB not to amortize goodwill.

Other concerns expressed in the SEC Report are that a principles-based approach would result in a loss of comparability and that regulators might not

[34] See http://frc.org.uk/frrp/press.

[35] This is the Liberty International case (see http://www.frc.org.uk/frrp/press/pub0267.html from 26 February 2002), which has been followed by a few other firms. As the assets involved were deemed to have an infinite life, the usual treatment of writing negative equity off to the income statement would have meant that negative goodwill would have been retained indefinitely in the balance sheet.

accept 'good faith' professional judgments (SEC, 2003, p. 14 at note 15). In the United Kingdom these problems do not appear to have occurred in any substantial way. Few complaints have been made about the U.K. accounting regime, at least under the ASB. Although the professional press does report some incorrectly applied standards or dubious judgments, these have amounted to only about ten important problems per year among the approximately 1,200 listed companies (excluding technical issues). All this evidence suggests that the principles-based system in the United Kingdom has worked fairly well, partly because even when rules in the form of statements produced by the ASB were instituted, the true and fair view still remained the overriding principle.

International Financial Reporting Standards

International Financial Reporting Standards (IFRS) are purportedly more principles-based than is U.S. GAAP and less permissive with respect to a true-and-fair override than is U.K. GAAP. This less specified GAAP-dominated approach results in less verbose standards than with rules-based standards.[36] An example is accounting for leases, wherein under both IFRS and U.S. GAAP a distinction is made between finance (capital) leases (which give rise to an asset and a liability) and an operating lease, which is not included in the balance sheet of the lessee. IAS 17 (22 pages) defines a finance lease (all others are operating leases) as 'a lease that transfers substantially all the risk of rewards incident to ownership of an asset' (IAS 17, para. 3). A lease is a finance lease when its term is for the 'major part' of an asset's economic life or the present value of the minimum lease payments are 'substantially all' of the fair value of the leased asset. In contrast, FAS 13 (48 pages) specifies bright-line rules. Under the broader more principles-based IAS, accountants might account for the same leases differently, depending on how they interpret 'a major part' and 'substantially all'.[37] Under the more specific FAS, a manager who wants to have a lease recorded as operating rather than financing can structure it to violate some prescribed requirement. Thus, both approaches might result in differences or be abused.

The IASB (and its predecessor, the IASC) has been struggling with the true-and-fair override, as it was torn between the U.K. and the U.S. approaches. Before 1997, it did not allow for a true-and-fair override and the IASB Framework still states:

> Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information. (Framework, para. 46)

[36] A notable exception is FAS 5 on loss contingencies, which is extremely thin relative to IAS 37. Ironically, FAS 5 was once voted as one of the best U.S. GAAP standards (Reither, 1998).

[37] In practice, there seems to be a tendency to appeal to the bright-line guidance in U.S. GAAP in interpreting IAS 17.

In 1997, a highly restrictive true-and-fair override was introduced by an amendment of IAS 1. Presumably, it was at the behest of the European Commission (which had an observer seat in the then IASC) to avoid conceptual differences with the accounting directives, which include a true-and-fair override. In its current version, IAS 1, *Presentation of Financial Statements*, states:

> Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. (IAS 1 [rev. 2003], para. 13)

But it also requires an entity to depart from a standard or interpretation if compliance 'would be so misleading that it would conflict with the objective of financial statements set out in the Framework' (IAS 1, para. 16). In that case it must make extensive disclosures in the notes. This is very much in line with the U.K. situation, and with the European accounting directives,[38] but caused controversy as the IASC did not want to include an override initially.

Recognizing that the override may conflict with the regulatory framework in some jurisdictions, in the 2003 revision of IAS 1, the IASB qualified the overriding principle and restricts it to cases in which the relevant national regulatory framework requires or permits a departure from a standard. Otherwise the company is required to make extensive disclosures. This appeal to country-specific jurisdiction is unprecedented in other IFRSs and is in contrast to the IASB's strategy to avoid a country differentiation in its standards.[39]

We are not aware of any studies that provide statistics on the use of the override in IFRSs, but casual observation suggests it is used only rarely, if ever.[40] This is not surprising, as in the past relatively few companies used IASB standards voluntarily and compliance was patchy and not enforced. In summary, the ability to use the override with IFRS is highly restricted. But the ability to use it where allowed nationally will allow comparisons to be made and provide some evidence as to the importance of an override for a well-functioning accounting standard setting system. New demands for the use of an override with IFRSs may be generated as the substantial majority of first-time adopters gain experience with IFRS

[38] Its introduction into the Fourth Directive reflected again the U.K.'s demands. It caused controversy in European countries, and there are countries that still have not incorporated it into national law (which presumably should be in conformity with the Directive).

[39] However, country-specific IFRS may also result if a country does not adopt full IFRSs but introduces modifications.

[40] Research by Company Reporting found only one example of an IFRS override. The European Aeronautic Defense and Space Company (EADS) in its 2001 and 2002 financial reports did not capitalize development as required by IAS 38, but now follows IAS 38 (Company Reporting, May 2005, see http://www.companyreporting.com). Although EADS justified this deviation as providing a better view of the firm, it did not formally invoke the override (nor did the auditor when it gave an exception to the audit opinion).

and discover problems in conveying the economic substance of the company under in this regime.

CONCLUSIONS AND SUGGESTIONS

The SEC (2003) Report states that the rules-based nature of U.S. GAAP has generated a mass of detailed rules and guidance and bright-line specifications in the standards encouraging financial engineering to meet the letter but not the intent of GAAP, resulting in less informative or misleading financial statements. We agree with this analysis and support the move towards principles-based standards suggested by the SEC and subsequently followed by the FASB's standard setting strategy. Due to the United States' status as lead example for international standard setting, this change in the format of U.S. GAAP has a significant impact also on other countries.

We are concerned, however, that standard setters do not seem to take into sufficient account that the format of standards and their contents are interdependent. In particular, the more judgment an accounting principle requires, the more difficult is it to cast it into a standard without plenty of guidance and, perhaps, exceptions. The FASB continues to permit and may well extend the fair measurement of assets and liabilities even though those valuations are often not based on relevant (applicable) and reliable (objectively determined) market prices. In our view the FASB will have to promulgate very detailed rules governing the permissible inputs to and applications of pricing alternatives even when ostensibly using a principles-based regime. Otherwise, on what basis could auditors challenge managers' assertions about appraisals, comparable prices and valuation-model inputs such as expected cash flows, probabilities and relevant discount rates? The result, we believe, will be a continuation and extension of the present rules-based accounting standards model, with all its attendant faults. This is an important reason for our preference for the traditional revenue/expense model, which provides more trustworthy and auditable procedures than the asset/liability approach in combination with fair value measurement.

We also advocate the inclusion of a true-and-fair override into GAAP standards, especially when these are rules-based. The more rules a standard includes the more conceivable is it that the rules contradict principles (and most likely that lower-level principles contradict higher-level principles). And thus, the more essential is an override with clear factual disclosure to sustain the main objectives of financial statements. This necessity is reinforced by noting that in a given regime rules develop over time with often inconsistent conclusions by the same or different standard setters. U.K. evidence does suggest that an override is not often needed in what is generally regarded as a principles-based regime. It is impossible to test our hypothesis of the need for such an override in a rules-based system. A true-and-fair override puts the responsibility for accounting judgments where it ultimately belongs—with managements and independent auditors. There is reason, though, for concern that some auditors would cave in to demands by opportunistic, overoptimistic or dishonest managers. These auditors might claim that, at the time that they accepted management-demanded exceptions, in their professional judgment those exceptions to GAAP that mislead investors were justified.

However, managers' use of and auditors' acceptance of (or, possibly, insistence on) a true-and-fair override would have to be disclosed and explained, which would allow users of financial statements and regulators to form their own opinion on the validity of the exceptions. Allowing companies some leeway to choose accounting, as long as the choices are accepted by their independent public accountants and are clearly disclosed, can offer investors useful insights on the way the managers view their enterprise. Indeed, U.K. experience is contrary to the assumption that auditors and regulators would give in easily. In contrast, opportunistic behaviour by U.S. corporations that have used strict adherence to GAAP rules to produce misleading financial reports has been a much worse outcome. Nevertheless, we recognize that the usefulness of a true-and-fair override relies on effective disciplinary measures against managers and auditors.[41] We would also add transparency to actions taken or not taken by bodies such as the U.S. Public Companies Accounting Oversight Board (PCAOB) to discipline rogue and incompetent auditors as well as recalcitrant firms. In the end, we agree with the FASB's (2004, p. 6) view that 'a move toward more objectives-oriented standards will require shifts in attitude, behavior, and expertise of preparers and auditors'. Unfortunately, FASB has not suggested measures to bring about such a shift.

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