

## PRINCIPLES- AND RULES-BASED ACCOUNTING DEBATE. IMPLICATIONS FOR AN EMERGENT COUNTRY

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*By a qualitative analysis, this research observes whether a principles-based system or a mixed version of it with the rules-based system, applied in Romania - an emergent country - is appropriate taking into account the mentalities, the traditions, and other cultural elements that were typical of a rules-based system. We support the statement that, even if certain contextual variables are common to other developed countries, their environments significantly differ. To be effective, financial reporting must reflect the firm's context in which it is functioning. The research has a deductive approach based on the analysis of the cultural factors and their influence in the last years. For Romania it is argue a lower accounting professionalism associated with a low level of ambiguity tolerance. For the stage analysed in this study (after the year 2005) the professional reasoning - a proxy for the accounting professional behaviour - took into consideration the fiscal and legal requirements rather than the accounting principles and judgments. The research suggest that the Romanian accounting practice and the professionals are not fully prepared for a principles-based system environment, associated with the ability to find undisclosed events, facing ambiguity, identifying inferred relationships and using intuition, respectively working with uncertainty. We therefore reach the conclusion that in Romania institutional amendments affecting the professional expertise would be needed. The accounting regulations must be chosen with great caution and they must answer and/ or be adjusted, even if the process would be delayed, to national values, behaviour of companies and individual expertise and beliefs. Secondly, the benefits of applying accounting reasoning in this country may be enhanced through a better understanding of their content and through practical exercise. Here regulatory bodies may intervene for organizing professional training programs and acting towards the improvement of the codes of conduct's effectiveness.*

*Keywords: emergent countries, rules or principles-based system, IFRS.*

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### **1. Introduction**

The study investigates on the relevance of the principles-based/ rules-based debate for the current accounting period and for an emergent country. By a qualitative analysis, this research observes whether a principles-based system (hereafter PBS) or a mixed version of it with the rules-based system (hereafter RBS), applied in Romania - an emergent country – is appropriate taking into account the mentalities, the traditions, and the cultural elements that are typical of a RBS. Particularly, it investigate, comparing to the accounting regulations for which it argue that, in Romania, are currently a mix of principles and rules, the extent to which principles- characteristic of the International Financial Accounting Standards (IFRS) that influenced financial reporting in this country- are applied at the practice level, which has been traditionally rules-based.

It starts from the PBS system versus the RBS system debate. This is related to the accounting systems classification. A review of the extremely rich literature on accounting systems classification is beyond the aim of this study restricted to reminding some of these valuable studies: Nair and Frank 1980; Nobes 1983; Joos and Lang 1994; Nobes 1998; Alexander and Archer 2001; D'Arcy 2001; Nobes 2004; Sellhorn and Gornik-Tomaszewski 2006; Rossignol

and Walliser 2007. Historically speaking the established groups of accounting systems were: Anglo-Saxon or Anglo-American (AS)- Continental-European (CE); common law- code law; principles based system (PBS)- rules based system (RBS); shareholder-oriented - stakeholder-oriented; investor- creditor protection. Between the above criteria, this study focused on PBS, respectively RBS.

The remainder of the paper is organized as follows: Section 2 presents reference to the items important for this research in the literature, Section 3 develop the qualitative analysis, and the final section comments on the compliance between accounting rules and accounting environment and concludes on the accounting perspectives for an emergent economy.

## **2. Principles- and rules-based accounting debate – a literature review**

Rating an accounting system as a principle- based or rules- based has become again topical after the financial scandals from the beginning of the 21<sup>st</sup> century, the most famous one being the Enron case, that have generated a crisis of confidence in financial reporting practice and regulation (McKernon and Kosmala 2007) mainly due to some companies that have followed the letter and not the spirit of the laws (Ball 2009). These scandals were the most impacting warning signals as to the need of changing the accounting environment from a rules - based one into a principles- based one in USA and from here in the entire world.

The PBS- RBS controversy features the Financial Accounting Standards Board (FASB), United States Security Exchange Commission (SEC) and the critics of standards or their actions. Being advocated the need to move towards a more principle-based financial reporting system, the FASB and the International Accounting Standard Board (IASB) signed the 'Norwalk agreement' (2004) aimed at the alignment of US GAAP and IFRS. It was agreed in this way that the American Standards are rather RBS, as opposed to IFRS that pertain to PBS. Therefore, the IASB conceptual framework is perceived as a guideline for both normalization and practice, whereas the FASB framework is just a guide for drawing up standards, the practice being dominated by rules (Feleagă 1999). However, there are opinions according to which the US GAAP are rules-based solely on the surface (due to their scope and treatment exceptions and detailed implementation guidance), de facto acting as a PBS (Schipper 2003; Ball 2009). Irrespective of these discussions regarding the American accounting system type, there certainly are difference between the US GAAP and IFRS and these should disappear with the purpose of converging the two sets of standards.

The descriptors of PBS are the fundamentals of accounting such as decision usefulness, true and fair view, going concern or substance over form. The system allows extensive opportunities for professional reasoning taking into consideration that specific requirements are kept to a minimum. This is also the talking point of the advocates of PBS which are scholars as well as standard setters from Anglo-Saxon countries. They also support the utility of this system which, having a deductive-normative approach, potentially gives more room for freedom of judgment to the practitioner (Feleagă 1999; Schipper 2003; McKernon and Kosmala 2007). Instead, a point is made on the laws and regulations (RBS) potentially affecting the degree of freedom and responsibility given to the accountant depriving the professional of bringing new interpretation and freshness of judgment to accounting decision-making. The Institute of Chartered Accountants of Scotland (ICAS 2006) argues that this system provides a comprehensive base and has flexibility to solve new test cases. The skeptics of PBS blame this flexibility that can be used to distort accounting information through earnings management (Nobes 2005). Finally, we note that the PBS, especially a genuine one (type A as per Alexander and Jermakowicz 2006) is supported by the concept of 'true and fair view' that in its turn raised an ongoing debate that will not be detailed in this study.

RBS is based on detailed provisions of solutions for most accounting cases, for which is unambiguously clear how and when it is to be applied. This system mentions and details what is or not is allowed. The main acknowledged advantage of RBS is that it increases financial information comparability facilitating auditors work in verifying the accounts (Schipper 2003). Even so, there are opinions that do not generalize the comparability advantage provided by RBS, suggesting that even such a system applied to various situations may lead to disclosure that causes confusions (Alexander and Jermakowicz 2006). Due to its stringency, in a RBS the professional have limited choices compared to PBS who give them latitude in accounting judgments (Feleagă 1999).

The main trend at this hour is the turn from rules to principles. His supporters argues for focusing attention on practice rather than on stipulated rules, that is what the companies are actually reporting (Ball 2009). It is asserted that this would enhance the professional, even moral judgment and as a consequence the truthfulness of financial reporting practices (McKernon and Kosmala 2007). The authors admit though that PBS is not infallible either, being prone, as well as its rival, to abuses. Pleading for recognizing the proper role of judgment in accounting practice, McKernan and Kosmala (2007) provides us with the solution of a gradual institutional change that includes a progressive relaxation of rules-dependency.

Within this frame of the current stage of the ongoing principles- and rules- based accounting debate, the present research singularizes the PBS- RBS typology to an emergent country, in the light of the IFRS tendency to spread worldwide (over 100 countries at this date, with plans for adoption by a number of others including United States by 2014). In order to analyze the Romanian accounting's evolution it is useful to mention that in literature, PBS is associated with a normalization based on conceptual framework, whereas RBS is associated with a normalization based on the chart of accounts. Also, generally speaking, PBS is superposed on the AS type accounting system and RBS is assimilated to an EC type.

### **3. Accounting in an economic emergent context – a qualitative analysis**

Aiming to discover whether a principles-based system or a mixed version of it with the rules-based system is appropriate to the accounting environment specific to the current stage in Romania, we investigated the potential to integrate the views in the literature on financial reporting differentiation, specifically on the PBS-RBS debate with the economic context of the emergent countries and the orientation of this countries over the IFRS. The research has a deductive approach based on the analysis of the cultural factors and their influence in the last years.

If we refer to developing and emergent countries, out of which many adopted the IFRS, we support the statement that, even if certain contextual variables are common to other developed countries, their environments significantly differ (Hoarau 1995; Mir and Rahaman 2005). To be effective, financial reporting must reflect the firm's context in which it is functioning. Moreover, choosing a set of accounting rules under the influence of the political factors, either external or internal, might prove to be inappropriate to the market's development level, the firms' incentives, or the evolution of the accounting profession, all of these being the drivers of the economic, legal and cultural factors. A significant discrepancy between rules and the environment which persists in time or a significant fluctuation of the accounting rules diminishes the role of financial reporting.

The research looks at the tendency towards PBS showed worldwide and assumes that the tendency is not suitable to any context. Particularly, it is preoccupied by IFRS spread across the world. It sets forth the question of whether this single set of high-quality global accounting standards, IFRS- supported as rules based on demonstrations that compare them to US GAAP or UK GAAP- bring real economical and social benefits due to the accountancy of developing and

emergent countries with traditionally rules- based accounting systems. Is it not that ‘creative compliance’ with IFRS, observable in some countries as a result of enforcing international standards, especially in developing and emergent countries, covers up a diminishing role of an accounting not harmonized with environmental factors? The present study sets out proof for this assertion first of all through the example offered by Eastern European countries today members of the European Community like Romania. During communism these countries had accounting systems that represented adjustments of the Soviet accounting system (RBS type) (Bailey 1995; Richard 1995); afterwards, in the post-communism pre-adherence to the European Union (EU) period they adopted the accounting systems of the EU members from Continental Europe with which they had cultural affinities and/ or that had economical influences on these countries (European-Continental accounting system type- thus RBS, as the case of Romania and its connections to the French system as elaborated in studies like Mătiș 2001; Feleagă and Ionașcu 1993; Ionașcu et al. 2007). In some cases IFRS were adopted by obtaining endorsed-IFRS (the case of Hungary brought into discussion in Fekete’s 2009 study). The same countries adopted IFRS for the consolidated accounts of the listed entities and they harmonized their national regulations with the Fourth European Directive, in the post-communism EU post- adherence period, resulting in- if we would like to quote Romania again- a mix of European recommendations, respectively of concepts and treatments extracted from IFRS. Along with the Eastern European countries, other studies offer examples of transition from RBS to IFRS (PBS), studies containing historiographies of some developing countries- e.g. Ong et al. (2004) for Taiwan- China that assert the difficulty of using the IFRS in the Far East’s practice, this one being anchored on rules; Mir and Rahaman (2005) for Bangladesh, country for which a very low compliance with IFRS is observed due to the pressure exerted by international lending institution considered an undemocratic process of adoption; Hassan (2008), who taking Egypt as a case study shows that new financial accounting rules need to be implemented after a deep investigation of the complexity of the social, political and economic context, especially for less developed country in transition; his findings suggest that Egyptian regulations harmonized with IFRS are not entirely to meet user’s needs. As similarities of these studies we may notice the caution even the suspicions with which either accounting professionals or users of financial reporting regard national regulations change over the IFRS.

Bringing the discussion on the Romanian context, it is firstly important to define the actual accounting system. In the current period, that can be localized after the year 2006, OMFP no.1752/2005 for approving Accounting Rules Harmonized with the European Directives is adopted, which requires all entities to apply accounting rules aligned with the European rules, starting with January 1<sup>st</sup>, 2006. This act was replaced in 2009 by OMFP no. 3055 on January 1<sup>st</sup>, 2010, which brings some updating in compliance with IFRS. The action of the Ministry of Public Finances is justified by Romania’s imminent integration with full rights in the EU, integration that materialized at the beginning of the following year. The entities formerly considered ‘large’ applying in the previous stage rules complying with IFRS (PBS type), had to adopt in the current stage the new rules of RBS essence. In this stage IFRS are mandatory for the credit institutions and optional for the other entities considered publicly accountable. The movement in circle (from a RBS system to a PBS system and back) continues for some entities – namely listed entities – together with the compulsory adoption of IFRS for their consolidated accounts on January 1<sup>st</sup>, 2007.

With respect to the appropriateness of the current accounting system for the Romanian environment, critics regarding the adaptation of IFRS are based on the insufficient education in Romania, from a cultural point of view (the mentality), technical (needed knowledge, practical experience of Romanian professionals), and legal (accounting was strongly anchored in fiscal rules). Ionașcu et al. (2007) quotes Roberts (2000) when he states, regarding the East European

countries, that the mixture of accounting philosophies through superposing of an Anglo-Saxon accounting system on a legalistic one is a cultural intrusion. In the same manner, Nobes (1998) shows that the introduction of a system of class A (AS type) in former communist countries might be inappropriate; except for the case in which a development of the capital market associated with the AS system is observed, like in the case of large or listed entities. Certain studies (Bailey 1995; Ionaşcu et al. 2007) show that cost-effectiveness of the respective changes was insignificant for the developing and emergent countries, at least during the implementation period. The difficult adjustment to the new accounting rules of emergent countries (mainly to IFRS) is confirmed by other studies as well, for example Bailey (1995), Ong et al. (2004), Ionaşcu et al. (2007), Fekete (2009).

### ***Discussion and conclusions***

At this time the views of most specialists on the prevalence of principles on the rules or, at most, a mix up of rules and principles. Rules should reinforce a principle rather than pre-empting or rendering it meaningless. For example, ICAS proposes a high level principle with a minimum of guidance. This should be associated with institutional and legal changes for reducing the number of rules and establishing guides, respectively with the development of accounting professional as expertise and ethics (ICAS 2006). It is also pointed out that RBS-PBS debate was based rather on political and polemical concerns than on conceptual ones (Alexander and Jermakowicz 2006). The same authors assert that the human behaviour is decisive for quality assurance of the financial reporting and for reflecting a fair image of the economic sphere. This viewpoint is also shared by Quinn (2003) who emphasizes that the most important aspect is honesty without which any system is vulnerable, including a PBS type. Good ethics and a good governance system would be needed. We notice the focus on people, on the personal behaviour, on the expertise and expert. These ideas are linked to the findings of studies focusing on the social character of the accounting that depict the movement towards a society increasingly populated by experts (Lowe 2004).

Based on these assertions, as concern the accounting Romanian future, it is to ask if the environmental factors, which we titled accounting environment, can support a PBS system.

Therefore, we will discuss on the Romanian environmental factors, stopping on the cultural ones. The cultural factors are implicit in the choice for accounting rules and within the accounting environment. Thus, we assert that choosing a RBS or a PBS accounting system (rules level) bears the print of cultural domination and cultural affinities of the country, together with the political choices. If we refer to this first dimension of the problem, as being the choice of accounting system – more rules or more principles based – we note the use of IFRS for a limited number of companies, respectively interferences of IFRS – PBS system on the rules applicable to other companies. That means that the European Directive, on which was ensured compliance of Romanian regulations, is influenced as well by IFRS and the PBS model.

Concerns the influence of the cultural factors on the accounting environment, we consider Hofstede's (1983) values discussed by Littrell and Lapadus (2005) for Romania, namely low individualism, uncertainty avoidance and high power distance. Gray (1988), while converting Hofstede's cultural values in accounting values, defines accounting professionalism in relation to the extent of individual professional reasoning in uncertainty accounting tasks. For Romania this means a lower accounting professionalism associated with a low level of ambiguity tolerance, argued also by Harding and Ming-Chuan's (2007) for China as a developing country, focusing on the cultural and social influential factors. If we also look to the accounting practice, we conclude that (also) in this stage, the professional reasoning - a proxy for the accounting professional behaviour - took into consideration the fiscal and legal requirements rather than the accounting

principles and judgments, assessment confirmed by the empirical study conducted by Buiga et al. (2010).

Finally, this synthetic qualitative analysis suggest that, related to a mix RBS-PBS accounting system, the Romanian accounting practice and the professionals are not fully prepared for a principles-based system environment. As Stevenson and Berger (2009) suggest, this kind of environment is associated with the ability to find undisclosed events, facing ambiguity, identifying inferred relationships and using intuition, respectively working with uncertainty, all these being closely related to the enforcement of the ethical behaviour. We therefore reach the conclusion that in Romania institutional amendments affecting the professional expertise would be needed. The accounting regulations must be chosen with great caution and they must answer and/ or be adjusted, even if the process would be delayed, to national values, behaviour of companies and individual expertise and beliefs. Secondly, the benefits of applying accounting reasoning in this country may be enhanced through a better understanding of their content and through practical exercise. Here regulatory bodies may intervene for organizing professional training programs and acting towards the improvement of the codes of conduct's effectiveness. The limits of the study are related to a certain themes which were not investigated enough in this space. Therefore, a future research can develop a description of the current Romanian accounting context, both in terms of rules, as well as practical level. Also, judging that the cultural dimension of the Romanian accounting presented above may not be completely verifiable at this date, it is recommended to extend this short study to the evolution of the profession in Romania, and to retesting of the cultural factors dimension.

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