

# Chapter 7

## Principles–Based Accounting Standards: A Slippery Slope to Financial Reporting Fraud

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### ABSTRACT

*Principles-based accounting standards (PBS) are imbued with high levels of flexibility that enable any company to apply accounting policies that suit its unique circumstances. The use of PBS necessarily leaves much room for extensive use of the ‘ingredients or elements of accounting flexibility’ including, estimates, multiple measurement types, and professional judgments to select accounting policies and make decisions around ‘materiality’. By invoking these flexibilities, entities can manipulate financial numbers and perpetuate improper acts that significantly impact the fairness of published general-purpose financial statements particularly the financial position and financial performance. This chapter concluded that while flexibility embedded in PBS is inevitable and necessary in financial reporting, its unintended consequence is to facilitate aggressive optimistic or pessimistic (as opposed to neutral) reporting practices. The flexibilities inherently pervasive in PBS can constitute the slippery slope through which fraudulent actions and reporting could be perpetuated.*

### INTRODUCTION

With the globalisation and internationalisation of financial and capital markets, there has been a need and call for the adoption of a single financial reporting language, i.e., a set of accounting standards, for use worldwide. Relevant literature identifies two main types of accounting standards: principles- and rule-based standards (Agoglia *et al.*, 2011; Cohen *et al.*, 2011; Peytcheva & Wright, 2011; Jamal & Tan, 2010; Segovia *et al.*, 2009). Principles-based standards (PBS) are epitomised by the International

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Financial Reporting Standards (IFRS) and the generally accepted accounting principles (GAAP) by the USA represent the rules-based standards (RBS). The rule-based standards require strict compliance with specific accounting rules and detailed implementation guidance (Nelson, 2003); hence they (the RBS) may not be readily suitable for worldwide application. The principles-based standards, unlike the RBS, can be adopted and implemented worldwide, in a variety of legal and cultural contexts, by companies that vary considerably in size, ownership structure, capital structure, political jurisdictions, and financial reporting sophistication (Schipper, 2005).

PBS derive from and are consistent with a framework, formally referred to as the *Conceptual Framework for Financial Reporting* (subsequently, *Conceptual Framework, 2018*) issued by the International Accounting Standards Board (IASB), the standard-setting body of the IFRS Foundation that was established in 2001 as an independent, public interest organisation (IFRS, 2018;). As stated in its Mission Statement, the IASB is committed to developing a single set of high-quality, global accounting Standards that provide high-quality, transparent and comparable information in general-purpose financial statements (IASB, 2015).

*“Our mission is to develop IFRS that brings transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability within the global economy.” (IASB, 2015)*

As the name suggests, principles-based standards are generic, they only provide principles and are flexible, allowing preparers of financial statements to apply judgment in the recording and reporting of transactions in a manner that provides a faithful representation of the underlying economic consequences of the relevant transactions and events (*Conceptual Framework, 2018*: chapter 2). PBS have the following characteristics:

1. each standard is drafted in clear, concise and plain language, consistent with the objectives set in the overarching, coherent *Conceptual Framework (2018)* that unifies the accounting system as a whole;
2. each standard states its accounting/financial reporting objective(s); financial statement preparers apply their judgment to decide how to fulfil the objective(s) contained in the particular standard that responds to users’ needs for clarity and transparency;
3. information from PBS is specifically defined and framed by the substantive objective(s) built into each pertinent standard in a manner that faithfully reflects the economic consequences of transactions, other events and conditions, and not merely their legal form.
4. each standard clearly articulates the class of transactions to which they apply and so preparers have a structure within which to make their judgements in determining the appropriate accounting for the company’s transactions (Ajekwe, 2022; Sunder, 2010; PwC, 2008; SEC, 2003; Rooijen, 2002; Herdman, 2002; Parfet, 2000; Brown, Collins & Thornton, 1993).

PBS are supported and adopted worldwide; approximately 120 nations and reporting jurisdictions permit or require IFRS for listed companies and approximately 90 countries have fully conformed to IFRS as promulgated by the IASB and include a statement acknowledging such conformity in audit reports (AICPA, 2022; Khan *et al.*, 2020). It is articulated that how PBS are not a comprehensive code of rigid rules that override the exercise of an informed judgment, explaining that each reporting accountant must

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