

Principle-based standards – where next?

Emotive terminology may have delayed progress on simpler standards that really work for companies and for their investors, argues UK regulator **Ian Wright**. Let's get on with putting the vision into practice before it's too late



Many column inches have been written asserting that IFRSs are principle-based standards and that their US counterparts are rule-based. The reality, you may be surprised to learn, is rather different. Both sets of standards start with very similar fundamental principles about the provision of relevant,

reliable information to support economic decision making. Yet even this proposition could be considered a rule that identifies one purpose for financial statements above all others.

So what is the real debate about – are we all at cross purposes and missing the point?

Principle-based and rule-based are in fact code for the historical outcomes of the standard-setting process. IFRS standards have higher-level rules for a relatively wider group of transactions and balances, compared to US GAAP, which has far more detailed rules, many of which apply to relatively narrow types of transactions.

One consequence of this difference is the size of the pile of literature. IFRS fanatics point out that the whole of IFRS can be captured in a single book (albeit with ever-reducing paper thickness), while their US friends don't actually know the thickness of the full pile of paper – there are so many different sources of what has become US GAAP.

Less emotion

If we were to use the 'higher-level rules' and 'more-detailed rules' language to describe our visions, might we reduce some of the emotion that surrounds the difference in style and approach between the US and non-US worlds? I hope so. The initiative by the CEOs of the major audit firms when they published a joint treatise on principle-based standards (see page 14) could be a turning point because it is acting as a catalyst for more detailed discussion. But what is missing is a clear vision of what should be happening next!

That paper talked primarily about outputs consistent with higher-level rules – standards that apply to a broad range of similar transactions with few exceptions, if any. But in one regard there may be some confusion and we may not yet have a meeting of the minds. The CEOs called for principle-based standards that require the use of judgement, but this doesn't quite capture what will benefit the market most. You might think that more detailed rules mean that there is less need for judgement because everything is spelled out. However, this is not the experience in the US,

where the complexity of rules means that experts spend huge amounts of time assessing 'when' to apply which rule, rather than 'how' to apply them, because there are so many rules that apply to a narrow set of circumstances. This, if you like, is the wrong kind of judgement – it is better to have higher-level rules and for the judgement to be around 'how' best to apply them.

More simplicity

Faced with a choice of a simple high-level rule or a complex requirement to assess many factors, I suspect that the vast majority of finance directors and investors would choose the former without hesitation. We need to remind ourselves that the most common purpose of accounting standard setting is to help companies raise capital at a reasonable cost and for investors to identify the most rewarding investment providing a reasonable return. If these two parties quickly agree that a simple rule can do the trick, it would seem bizarre for any other parties to stop this happening.

Of course business transactions are often highly complex and similar economics can be captured in different legal structures, so it is highly unlikely that a simple rule (which many will describe as a principle) will be available every time. For example, what we know from experience is that we can't write a simple rule that can be applied to determine whether a company controls another entity and so should be consolidated. So we need to agree a vision for how and when it is necessary to abandon a search for a simple rule and instead to describe the characteristics that need to be evaluated using judgement brought to bear by experienced management and auditors.

All this may seem somewhat academic, but actually it is deadly serious. The prospect of the US market moving to IFRS has become a reality, and many now characterise the debate as being about 'when' rather than 'if' that happens. US stakeholders are likely to have difficulty in understanding the culture that has been embedded in the vast majority of IFRS standards (IAS 39 being a notable exception) and we need to get agreement on the style of future standards before an excessive amount of US GAAP history gets adopted as if it is IFRS guidance.

If the major firms could produce a few high-level examples of their vision for principles-based standards within the next few months, there is the potential to progress this debate before more detailed rules get locked into future IFRSs – it will be really hard to recover lost ground at a later date.

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