THE SENSIBILITY OF PRINCIPLES-BASED ACCOUNTING STANDARDS

FINANCIAL ACCOUNTING WOULD BE MORE ACCURATE IF THERE WERE FEWER RULES—INCLUDING FEWER RULES FOR VALUING STOCK OPTIONS.

BY RONALD M. MANO, CPA, AND MATTHEW L. MOURITSEN

The Financial Accounting Standards Board (FASB) had been trying to resolve the issues about measuring the expense of stock options long before it published its Proposed Statement of Financial Accounting Standards, "Share-Based Payment," in March. But instead of wrangling over valuation details, we believe the Board should avoid this type of rules-based accounting. Instead, it should issue a principle of accounting for stock options and let the accountants deal with the specifics of how to measure the size of the expense. For that matter, the FASB shouldn't issue rules at all—only principles.

MIND OVER MATTER

Nowhere have we seen the idea of rules- vs. principles-based accounting articulated better than in an ad from PricewaterhouseCoopers circa April 2003. So let's begin by quoting the ad verbatim:

Principles Have No Loopholes

In quest of growth, more than a few in corporate America accepted the illusion of growth and now investors, companies and the economy are paying dearly. What are the remedies? Moving from a rules-based accounting system to principles-based standards could have a significant impact on eliminating some of the accounting abuses that have helped foster this illusion. So exactly how do principles-based accounting standards differ from our current rules-based systems and how will they make things better? Rules-based systems encourage creativity (and not the good kind) in financial reporting. They allow some to stretch the limits of what is permissible under the law, even though it may not be ethically or morally acceptable. A principles-based system requires companies to report and auditors to audit the substance or business purpose of transactions; not merely whether they can qualify as acceptable under incredibly complex or overly technical rules. A rules-based system allows managers to ignore the substance and, instead ask, "Where in the rules does it say I can't do this?"

A principles-based system places the onus on managers—and the auditors—to exercise professional judgment to ensure that the accounting interpretation is fair and reasonable. Knowing that reported financial information is based on what has actually happened as opposed to what has been engineered is what investors need to help them make decisions—decisions based on better information and greater transparency. Recognizing that beyond financial reports, an honest and candid description of the health of a business is what is really called for today.

Yes, this will require a new perspective on what public companies communicate with their public. Management must be willing to share not just historical information, but also the critical strategic information they need to make decisions moving forward. A principles-based approach would make obsolete the question of how data can be spun to look better to investors.

Auditors will have to be more engaged in determining whether the information presented gives a clear and transparent view of a company's operation, rather than whether technical requirements have been met. We will not have another chance to rebuild public trust. Changes must be made and each individual, whether management or auditor, must live up to his or her personal obligation. *(Reprinted with permission from PricewaterhouseCoopers LLC.)*

OUR OBSERVATIONS

We applaud PricewaterhouseCoopers for taking this bold stand in favor of principles-based accounting standards.

Another pithy way of making this point came in 1972 from now-retired professor Robert R. Sterling of Rice University, the University of Kansas, and the University of Utah: "It is much easier and more diplomatic to accuse someone of breaking a rule than to accuse him of telling a lie."

Herein lies the problem that we external accountants have created: We haven't been willing to accuse our clients of telling a lie. We've allowed any sort of accounting the client was willing to promote unless there was a rule saying we couldn't. In many cases, the client accountant who was promoting the aggressive accounting had been the manager or partner on the job a few years earlier before taking the job with the client.

Let's illustrate our point of view.

Several years ago we met with Wayne Welsh, the internal auditor of the Utah state government, and he asked us if we understood "condition" and "criteria." We didn't know what he was talking about. Wayne then taught us what the words mean regarding internal auditing. "Criteria" are the way things ought to be based on best business practices. "Condition" is the way things actually are. The difference between the two is what internal auditors call a "finding." Wayne said the internal auditor must evaluate the situation and determine "criteria" based on his or her opinion of what the best practices would be. There's no rulebook for the internal auditor to use. Each situation is different and demands a different set of analysis skills, and the auditor must decide what the best practice is. In other words, as the PwC ad says, "A principles-based system requires companies to report and auditors to audit the substance or business purpose of transactions."

Now let's contrast the internal auditor's "criteria" with the external auditor's "criteria."

Under the present system, "criteria" in internal auditing would be principles-based accounting, and "criteria" to external auditors would be rules-based accounting. The external auditor refers to the rules: GAAP (generally accepted accounting principles). He or she then applies those rules, and, if there's any way to squeeze the client's practice into the confines of GAAP, the external auditor declares that the practice is "fairly presented in accordance with GAAP." The external auditor might not even agree with the financial statement presentation but supports it because somehow the company's management got it to fit within the rules. Or, in PwC's words, managers "can ignore the substance and, instead, ask, 'Where in the rules does it say I can't do this?'" There is no commitment to the rule for the external auditor as there must be a commitment to "criteria" for the internal auditor. The external auditor is unwilling to accuse the client of telling a lie even if he or she believes the presentation isn't truthful accounting. Thus we have "Enrons." Because the auditor didn't have to accuse the client of breaking a rule and was apparently unwilling to accuse him or her of telling a lie, the company's financial statements showed a profit when the firm was heading straight toward bankruptcy.

We strongly agree with PwC that we need principles-based accounting. We need our external auditors to take some ownership of the criteria that they apply when they profess that the financial statements are "fairly presented."

Three decades ago, Robert Sterling gave us the recipe that would have prevented the accounting fraud we've witnessed. It's about time that we begin to heed his wise words to help prevent accounting deceptions.

Now let's turn to the notion of principles-based accounting for stock options.

ACCOUNTING FOR STOCK OPTIONS

We completely agree with the FASB that stock options are an expense and should be treated as one in financial statements. Expensing stock options is the principle, but using a formula to value them would be a rule. Many people have argued that we should expense stock options only if they can be measured accurately. But there are only two numbers on the financial statements that can be measured accurately: cash and accounts payable. Every other number is an estimate. So our recommendation to the FASB is avoid getting bogged down trying to develop a rule that's supposed to measure the amount of the expense. No rule—or formula—can "accurately measure" the cost of stock options.

Just as internal auditors must evaluate for condition and criteria, external auditors and internal accountants are capable of measuring the amount of the expense of stock options. Surely that's who should develop the right algorithm to measure the value of the stock options. It would be virtually impossible for the members of the FASB to develop a formula for valuing the cost of stock options that would work for every company. Only the people intimately familiar with a company could develop the formula. When it comes down to the final rule, the FASB should issue a principles-based one and let the accountants in the field come up with the rules that fit their own situation. In other words, let them use more "professional judgment."

Long before we—two old professors—even thought about becoming accountants, the accounting profession had professed it used professional judgment. It seems it has been lip-service only. We constantly tell students and accounting professionals that they should use professional judgment and then provide GAAP's detailed rules that say, "I *can* do this."

It's time we allowed—insisted—that accountants truly use their professional judgment. Let's insist that in-house accountants and external auditors exercise professional judgment—just as internal auditors do to determine the correct "criteria."

That's why we believe it's time we allow the FASB do its job of setting accounting standards, not accounting rules, and let accountants and auditors—internal and external—figure out correct "criteria" and, thereby, the correct number. This is our chance, as the ad says, to "rebuild public trust." ■

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