

**RULE BASED ACCOUNTING STANDARDS VS PRINCIPLE
BASED ACCOUNTING STANDARDS: A Critical Examination
on Selected Sri Lanka Accounting Standards**

By

AMJ Attanayake
GS/MC/1266/2000

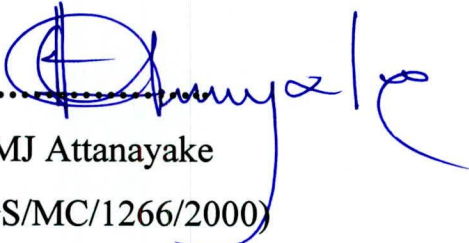
A dissertation
Submitted to the University of Sri Jayewardenepura
In partial fulfilment of the requirement for the degree of
Master of Science in Management

M.Sc (Management) Program
Faculty of Graduate Studies
University of Sri Jayewardenepura

July 2006

AUTHOR'S DECLARATION

The work described in the thesis was carried out by me under the supervision of Prof.MW Wickramarachchi and a report on this has not been submitted in whole or in part to any university or any other institution for another Degree/Diploma.


.....
AMJ Attanayake
(GS/MC/1266/2000)

Author

CERTIFICATION

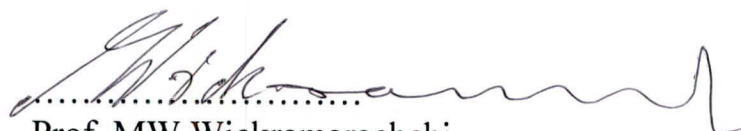
I hereby recommend that the thesis was prepared under my supervision

By

AMJ Attanayake
(GS/MC/1266/2000)

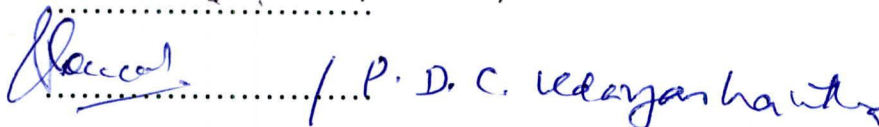
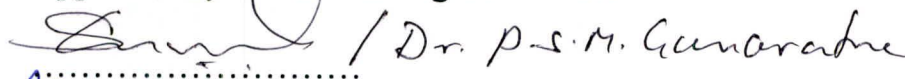
**Entitled: RULE BASED ACCOUNTING STANDARDS VS
PRINCIPLE BASED ACCOUNTING STANDARDS: A
Critical Examination on Selected Sri Lanka Accounting
Standards**

Accepted in partial fulfilment of the requirements for the degree of Master of
Science in Management.



Prof. MW Wickramarachchi
Thesis Advisor

Approved by the Examining Committee



M.Sc (Management) Program
Faculty of Graduate Studies
University of Sri Jayewardenepura

July 2006

ACKNOWLEDGEMENT

First and foremost, I am indebted to Prof. MW Wickramarachchi, Senior Lecturer, Department of Accounting, University of Sri Jayewardenepura who supervised the study by giving insight, valuable advices, guidance, inspirations and generous scarification of his valuable time, leaving his obligatory commitments away with incredible humility in spite of his busy schedules in the university.

I would also like to thank Dr.Sampath Amarathunge, the early coordinator in the M.Sc Degree Program Unit, for his genuine interest, understanding and the kindness extended towards the success of students and to the present coordinator Dr PD Nimal for his courteous support.

I wish to offer my sincere thanks to Prof. David Alexander, Professor in Accounting, University of Birmingham, who developed the world accepted definition for Principle Based Accounting Standards, for sending his latest studies with valuable comments and Mr. PJ Jayathilake, Head Department of Business Management, University of Sabaragamuwa, for his continuous support. A special thanks due to my colleague, Mr. H.G Piyasiri who split his intellectuality generously for the success of the study.

My heartfelt thanks go to Mr.NRP.Alexander, who taught me the alphabet of accounting, at the Passara Central College and Mr.Ashoka Jayasinghe, Senior Partner, Jayasinghe & Company, Chartered Accountants, who enlighten my professional life in accounting.

Without the help, moral support, and care with patience of my wife, Kanthi and my little Hiru who taught me the life, I could not have completed this in time. I acknowledge their wholehearted support with thanks.

If you have not scarified your whole life for me, my dear parents, this would not have become a reality. Therefore I dedicate honestly the results of entire effort to you.

ABSTRACT

Rule Based Accounting Standards Vs Principle Based Accounting Standards: A Critical Examination on Selected Sri Lanka Accounting Standards

Debacle of Enron and the other large accounting scandals in the world placed the accounting professionals in a verge of dilemma with a debate of Rule Based Accounting Standards vs. Principles Based Accounting Standards. The challenge was constituted by the Sarbanes–Oxley Act of 2002 designating the Security Exchange Commission (SEC) to submit a study report to the US congress on the feasibility of steering towards the Principle Based Accounting Standards from Rule Based Accounting Standards.

The purpose of the study was to become aware of whether the Sri Lanka Accounting Standards (SLAS) contained the characteristics of Rule Based Accounting Standards and to assess the appropriateness of the provisions of SLAS which include such characteristics in terms of the definition of Principle Based Accounting Standards.

Based on the articulated definition of Rule Based Accounting Standards and Principle Based Accounting Standards, selected SLAS were examined critically with a holistic perspective.

The study revealed that all examined SLAS contained a substantial amount of Specific Criteria, Examples, Exceptions, Subsequent Precedents, Implementation Guidelines and Determinate Rules. In Addition, the study ascertained that they also contained a considerable number of Bright-line Thresholds and few Scope Restrictions.

The study concluded that all the characteristics of Rule Based Accounting Standards included in the SLAS should be eliminated to the extent possible, leaving an ample scope for the exercise of professional judgment. And the study recommended embodying the provisions to the SLAS which represent the reality with true and fair reflection of economic substance of Objective Based Accounting Standard.

TABLE OF CONTENTS

	Page
Acknowledgement	I
Abstract	II
Table of Content	III
List of Table	IX
List of Figures	X
CHAPTER ONE: Introduction	01-07
1.1 Background	01
1.2 Research Problem	01
1.3 Objectives of the Study	02
1.4 Justification	03
1.5 Limitation of the Study	04
1.6 Concepts & Terms	04
1.7 Research Methodology	05
1.7.1 Research Design	05
1.7.2 Sample	06
1.7.3 Method of Data Collection	06
1.7.4 Data Analysis	06
1.8 Structure of the Final Report	07
CHAPTER TWO: Literature Review	08-42
2.1 Preamble	08
2.2 Review of Prior Studies	09
2.2.1 Schipper, K. (2003) Principle Based Accounting Standards	09

2.2.1.1	Objective of this study	09
2.2.1.2	Methodology and the summary of contents	09
2.2.1.3	Conclusions and comments	09
2.2.2	Nobes, C. (2005) Rule Based Standards and the lack of Principles in Accounting	10
2.2.2.1	Objective of this study	10
2.2.2.2	Methodology and the summary of contents	11
2.2.2.3	Conclusions and comments	11
2.2.3	Nelson, M.W., (2003). Behavioural Evidence on the Effects of Principles and Rule Based Standards	12
2.2.3.1	Objective of this study	12
2.2.3.2	Methodology and the summary of contents	12
2.2.3.3	Conclusions and comments	13
2.2.4	Staubus, G.J., (2004) On Brian P. West's Professionalism And Accounting Rules	13
2.2.4.1	Objective of this study	13
2.2.4.2	Methodology and the summary of contents	14
2.2.4.3	Conclusions and comments	14
2.2.5	Boone, J.P. and K.K.Raman., (2004) Principle vs. Rules Based Standards; Does Accounting Discretion Increase the Quality of the Reported Earnings.	15
2.2.5.1	Objective of this study	15
2.2.5.2	Methodology and the summary of contents	15
2.2.5.3	Conclusions and comments	15
2.2.6	Webster, E. and D.B.Thornton., (2004) Earning Quality Under rules –vs. Principle Based Accounting Standards : A Test of the Skinner Hypothesis	16
2.2.6.1	Objective of this study	16
2.2.6.2	Methodology and the summary of contents	16
2.2.6.3	Conclusions and comments	16

2.2.7	Warnock, K., (1997) On the Nature of Rules in Accounting	17
2.2.7.1	Objective of this study	17
2.2.7.2	Methodology and the summary of contents	17
2.2.7.3	Conclusions and comments	18
2.2.8	Ijiri, y., (2005) US Accounting Standards and Their Environment: A Dualistic Study of Their 75-Years of Transition	18
2.2.8.1	Objective of this study	18
2.2.8.2	Methodology and the summary of contents	18
2.2.8.3	Conclusions and comments	19
2.2.9	Shortridge, R.T. and M. Myring., (2005) Defining Principles-Based Accounting Standards.	20
2.2.9.1	Objective of this study	20
2.2.9.2	Methodology and the summary of contents	20
2.2.9.3	Conclusions and comments	21
2.2.10	Alexander, D. and Jermakowicz, E.K. (2005). A True and Fair View of the Principles/ Rules Debate.	22
2.2.10.1	Objective of this study	22
2.2.10.2	Methodology and the summary of contents	22
2.2.10.3	Conclusions and comments	26
2.2.11	Levin, J.A., (2004) Issues Relevant to New Accounting Standards in a Compliance Programme.	27
2.2.11.1	Objective of this study	27
2.2.11.2	Methodology and the summary of contents	27
2.2.11.3	Conclusions and comments	29
2.2.12	Levit, A. (1998) The Importance of High Quality Accounting Standards	30
2.2.12.1	Objective of this study	30

2.2.12.2 Methodology and the summary of contents	30
2.2.12.3 Conclusions and comments	32
2.2.13 Amenic, J. and R. Craig., (2004) Reform in Accounting Education in the Post-Enron Era: Moving accounting “Out of Shadows”	32
2.2.13.1 Objective of the study	32
2.2.13.2 Methodology and the summary of contents	33
2.2.13.3 Conclusions and comments	34
2.2.14 Choi, Y.C. and I.N. McCarthy (2003) FASB Proposes Principle-Based Approach to US Standards Setting.	35
2.2.14.1 Objective of the study	35
2.2.14.2 Methodology and the summary of contents	35
2.2.14.3 Conclusions and comments	38
2.2.15 Reither, C.L. (1997) How the FASB Approaches A Standard Setting Issue.	38
2.2.15.1 Objective of the study	38
2.2.15.2 Methodology and the summary of contents	39
2.2.15.3 Conclusions and comments	42
2.3 Summary	42
CHAPTER THREE: Debate of Rule Based Accounting and Principle Based accounting:	43-63
3.1 Introduction	43
3.2 Criticisms of Rule Based Approach to Accounting	43
3.3 Rationalization of Rule Based Accounting	63
3.4 Summary	69

CHAPTER FOUR: Review of SLAS with Reference To Rule Based Accounting Standards and Principle Based Accounting Standards 70-86

4.1 Definitions of Principle Based Standards and Rule Based Standards	70
4.1.1 Principle Based Accounting Standards	70
4.1.2 Rule Based Accounting Standards	72
4.2 A Review of Some Specific Accounting Standards	73
4.2.1 Sri Lanka Accounting Standard SLAS 5 (Revised 2005) : Inventories	73
4.2.2 Sri Lanka Accounting Standard SLAS 18 (Revised 2005) : Property, Plant & Equipment	74
4.2.3 Sri Lanka Accounting Standard SLAS 20: Borrowing Costs	74
4.2.4 Sri Lanka Accounting Standard SLAS 22: Accounting for Investments	75
4.2.5 Sri Lanka Accounting Standard SLAS 23: Revenue Recognition and Disclosures in the Financial Statements of Banks	77
4.2.6 Sri Lanka Accounting Standard SLAS 24: Accounting For Government Grants and Disclosure of Government Assistance	79
4.2.7 Sri Lanka Accounting Standard SLAS 25: (Revised 2004) Business Combinations	81
4.2.8 Sri Lanka Accounting Standard SLAS 26 :(Revised 2005) Consolidated and Separate Financial Statements	82
4.2.9 Sri Lanka Accounting Standard SLAS 37: Intangible Assets	83
4.2.10 Sri Lanka Accounting Standard SLAS 41: Impairment of Assets	85
4.3 Summary	86

CHAPTER FIVE: Conclusions and Recommendations	87-90
5.1 Motivation to Study and Objectives	87
5.2 Findings and Recommendations	88
5.2.1 Specific conclusions	88
5.2.2 General Conclusions	89
5.2.3 Recommendations	89
5.3 Further Developments	90
REFERENCES	91-96

LIST OF TABLES

	Page
2.1 Three Levels of Accounting and Financial Reporting Regulations	23
4.1 Assessment of SLAS in Terms of Rule Based Characteristics	86

LIST OF FIGURES

	Page
2.1 Simplified Schemes of IASB Concepts	24
2.2 Hierarchies of Accounting Qualities	40

CHAPTER ONE

INTRODUCTION

1.1 Background

At present there are many discussions about rule based accounting standards and principle based accounting standards. With the expansion of industry and business during the last century, the discipline of accounting evolves through setting standards.

The process of setting accounting standards was highly criticized at the debacle of Enron. The Accounting profession and the governing bodies of accounting were also highly accused and criticized in terms of setting accounting standards through lengthy rules. Especially Security Exchange Commission (SEC) in USA and investors urged to take up principle based revamp moving towards a principle based standards setting process, cutting cumbersome lengthy rules. In the Financial Times of 10th February, Professor Niall Lothian is quoted as saying that accountants who do not have degrees in accountancy are driven to look up the cookbook of instructions rather than thinking through the issues. Professor David Hatherly is quoted as stressing the need for a profession sure of its own thought process and not seeking refuge in rules. In response to these concerns, growing number of stakeholders and Security Exchange Commission of USA endorsed the adoption of broader principle based standards replacing rule based standards.

1.2 Research Problem

After big accounting scandals like Enron, WorldCom, Global Crossing, Tyco and Adelphi, regulatory mechanisms of accounting in USA, UK and the other countries intensified the scrutiny of accounting standards to see whether their accounting standards are rule based or principle based.

When a country's accounting standards contain characteristics of rule based accounting standards such as specific criteria, bright-line thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidelines, determinants and indeterminate rules it tends to stray the professionalism because rules in accounting reduce the scope of professionals exercising a professional judgement. No profession could survive the imposition of rigid code of rules and regulations rather than relying on the exercise of judgment in the application and determination of methods and procedures to achieve an objective. Especially the accounting profession will not serve the public interest by confining its practitioner's stand-in rule based accounting standards which does not ensure the primacy of true and fair view and economic substance. The professional accountants in Sri Lanka are bounded by the law and practice to apply The Sri Lanka Accounting Standards (SLAS) which are based on International Accounting Standards(IAS), constitute by The Institute of Chartered Accountants of Sri Lanka(ICASL). A key contemporary query which has to find clarification in Sri Lanka is that the present SLAS contain rules.

1.3 Objectives of the Study

The overall objective of the study is to examine the selected Sri Lanka Accounting Standards to see whether they contain rules with reference to the characteristics of rule based accounting standards and principle based accounting standards. In the study, the researcher expects to achieve the following specific objectives;

1. To identify the characteristics of rule based accounting standards such as specific criteria, bright-line thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidelines, determinants and indeterminate rules in the selected SLAS.
2. To assess the appropriateness of provisions of SLAS which contain the characteristics of rule based accounting standards with reference to the characteristics of principle based accounting standards.