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Principles-Based Accounting Standards and Corporate Governance Considerations

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Abstract: This paper examines the implications of principles-based versus rules-based accounting standards, specifically as related to corporate governance. The debate over the benefits and consequences of principles-based versus rules-based accounting standards has ensued for decades. However, comparing the approaches in a real-life, practical setting has proved challenging. Principles-based standards require increased managerial judgement, which should necessitate the need for effective oversight by those responsible for corporate governance. This paper examines corporate governance surrounding the implementation of guidance under a principles-based piece of guidance that was subsequently supplemented with additional rules-based guidance in order to better enforce the intent of the original principles-based guidance. Many firms needed the subsequent rules-based guidance in order to comply with the original intent of the principles-based guidance. While firms complying with both the principles-based and rules-based guidance in this study tend to exhibit characteristics of stronger corporate governance, that does not necessarily indicate that stronger corporate governance determines compliance with principles-based standards. These findings should be of interest to practitioners and regulators, and are important given the ongoing movement toward principles-based standards. The SEC is exploring whether existing prescriptive guidance in Regulation S-K should be replaced with a principles-based framework for financial disclosures (SEC, 2016). This paper capitalizes on a unique setting to provide a fresh analysis in the debate between principles-based and rules-based accounting standards.

Keywords: disclosure; financial reporting; rules-based; corporate; environment

JEL Classifications: G30; M41; Q56

Introduction

The debate over the benefits and consequences of principles-based versus rules-based accounting standards has ensued for decades. This issue remains relevant today given the new principles-orientated guidance in ASC Topic 606, *Revenue from Contracts with Customers* and ASC Topic 842, *Leases*. Following the passage of The Sarbanes-Oxley Act of 2002, the SEC directed the FASB to "more consistently develop standards on a principles-based or objectives-oriented basis" (SEC 2003a, 4). Compared to rules-based standards, principles-based standards leave more room for varying interpretation, and are characterized by clearly defined objectives, fewer scope exceptions, and less implementation guidance. The SEC identified SFAS No. 143, *Accounting for Asset Retirement Obligations* (AROs) as one of the earliest accounting standards with principles-based qualities. This context (ARO guidance) is utilized in this paper in order to examine the implications of principles-based versus rules-based accounting standards. Given the unique implementation related to this

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guidance, this context provides a rare opportunity to examine principles-based versus rules-based standards.

SFAS No. 143 was effective in 2003 and provided guidance for obligations associated with the retirement of long-lived assets (FASB, 2001). AROs are measured at fair value when a reasonable estimate can be made, and are recognized in the period incurred. AROs require significant judgment by management concerning the timing, measurement, and potential settlement dates. Formal guidance was required in order to promote consistent treatment given the diversity in then-existing accounting practices. Upon adoption, entities recognized a cumulative ARO liability, a related asset and accumulated depreciation, and a cumulative-effect adjustment to income under then-APB Opinion No. 20, *Accounting Changes*.

In 2004, the FASB identified diversity in the adoption of SFAS No. 143 and noncompliance with its underlying principles, particularly with respect to "conditional" AROs (FASB, 2005). Conditional AROs result when the timing of the asset retirement or method of settlement is dependent on future events that may or may not occur. Some entities properly incorporated uncertainty into the estimate of fair value; others incorrectly applied the "probable and reasonably estimable" guidance under then-SFAS No. 5, *Accounting for Contingencies* (now ASC Topic 450). Soon after, the FASB issued Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations* that was effective in 2005. FIN 47 clarified the accounting principles for particular types of AROs already set forth in SFAS No. 143. FIN 47 resulted in the recognition of additional long-term liabilities and a cumulative effect adjustment to income for previously unrecognized obligations. In effect, many firms needed two chances to theoretically comply with the original intent of SFAS No. 143. It should be noted that accounting for AROs now resides in ASC Topic 410, *Asset Retirement and Environmental Obligations*.

Principles-based standards remain integral to the U.S. financial reporting environment and require management to exercise greater judgement during the implementation and application of such standards, which may necessitate the need for effective oversight by those responsible for corporate governance. This article provides insights into these issues by examining the adoption of SFAS No. 143. While findings suggest that firms reporting ARO adjustments upon adoption of the standard tend to exhibit characteristics of stronger corporate governance, that does not necessarily indicate that stronger corporate governance determines compliance with principles-based standards.

Methodology

The 2003 *Fortune 500* was used to examine managements' initial ARO adoption decisions under SFAS No. 143, and the 2005 *Fortune 500* was used to examine the adoption of FIN 47. The samples were adjusted to exclude financial institutions and firms lacking data mainly due to mergers, acquisitions and bankruptcy. Financial institutions are excluded due to their unique financial characteristics and oversight by regulatory bodies. This results in a subtotal of 339 firms. An additional 47 firms that reached the *Fortune 500* in 2005 were added to this sample. The final samples comprise the same 386 firms for 2003 and 2005.

The 2003 10-K report for each firm was examined to determine whether the SFAS No. 143 adoption decision was "material" or "not material." A decision is classified as material if management discussed the adoption of SFAS No. 143 in the footnotes and recognized an adjustment to the income statement and balance sheet. A decision was coded as not material if management disclosed that the issuance of SFAS No. 143 did not have a material effect on the financial statements, or was silent as to the new standard. A similar examination was performed for FIN 47 for 2005.

Table 1 summarizes the ARO adoption decisions of the sample firms for 2003 and 2005, and reflects comparable findings between the two periods. Of the 386 firms in each sample year, 104 (27 percent) reported an adjustment upon adoption of SFAS No. 143. In addition, 94 firms (24 percent) reported an adjustment upon adoption of FIN 47, which is consistent with the FASB's concerns over the lack of compliance with SFAS No. 143. The industry composition of firms recognizing new AROs in each year indicates that firms in the extractive (12), transportation (13), and electric, gas and sanitary services (38) industries comprise over 60 percent (63/104) of firms reporting an adoption adjustment in 2003. In 2005 these three industries comprise 52 percent (49/94) of firms reporting an adjustment. It should also be noted that 53 firms reported ARO adjustments in both 2003 and 2005.

Table 1

Adoption of SFAS No. 143 and FIN 47: Analysis and Industry Classification

	SFAS No. 143: 2003		FIN 47: 2005		
Industry Description	**Material** [1]	**Not Material**	**Material** [2]	**Not Material**	**Material in 2003 & 2005** [3]
Mining and construction	3	4	0	7	0
Food	1	23	6	18	0
Textiles and printing/publishing	5	18	4	19	0
Chemicals	9	9	4	14	3
Extractive	12	4	7	9	3
Durable manufacturers	8	63	17	54	6
Transportation	13	21	7	27	6
Electric, Gas, and Sanitary Services	38	5	35	8	32
Retail	7	79	6	80	1
Other (Computers, Services, Pharmaceuticals)	8	56	8	56	2
Subtotal	**104**	**282**	**94**	**292**	**53**
Total		N = **386**		N= **386**	

[1] Represents firms that recorded ARO adjustments upon adoption of SFAS No. 143.

[2] Represents firms that recorded ARO adjustments upon adoption of FIN 47.

[3] Represents firms that recorded ARO adjustments upon adoption of both SFAS No. 143 and FIN 47.

The following corporate governance variables are then considered:

Variable	Definition
BOARD	Number of individuals on the board of directors.
INSIDEDIR%	Number of inside directors, divided by the total number of directors.
INSIDEOWN%	Percentage of voting shares owned by officers, directors, and other defined individuals.
AC_SIZE	Number of directors on the audit committee.
AC_EXPERT	A binary variable equal to 1 if all audit committee members are designated as financial experts, and 0 otherwise.
BIG4	A binary variable equal to 1 if a company is audited by a Big 4 auditor, and 0 otherwise.

Data for the variables *BOARD*, *INSIDEDIR%*, *INSIDEOWN%*, *AC_SIZE* and *AC_EXPERT* is obtained from Corporate Library and BoardEx, and supplemented by firm 10-K Reports and Proxy Statements. Data for *BIG4* is obtained from Compustat. In general, corporate governance effectiveness should be positively related to *BOARD*, *AC_SIZE*, *AC_EXPERT* and *BIG4*, and negatively related to *INSIDEDIR%* and *INSIDEOWN%* (Zhang et al., 2007; Lin and Hwang, 2010).

Findings

Corporate Governance Characteristics

Each variable is first examined to identify any significant shifts in corporate governance mechanisms between 2003 and 2005. In these untabulated findings, there are no statistically significant differences in means for five of the variables (*BOARD*, *INSIDEOWN%*, *AC_SIZE*, *AC_EXPERT*, and *BIG4*) during the period. However, the 2005 firms have fewer insiders on the board of directors (*INSIDEDIR%)* compared to 2003 (mean of 21 percent vs. 27 percent, respectively), and the difference is statistically significant. This change is related to rules established by the New York Stock Exchange and NASDAQ in 2002 requiring boards of listed companies to have a majority of independent directors (SEC, 2003b).

Adoption of SFAS No. 143

The next analysis examines each corporate governance variable in conjunction with managements' decisions when SFAS No. 143 was adopted. Recall that 104 of the 386 firms recorded an adjustment upon adoption and are classified as "material" while the other 282 firms concluded that the impact was "not material." Table 2 presents descriptive information and tests of the differences for each variable between the two groups. The findings indicate statistically significant differences in means for five of the six corporate governance attributes. More specifically, "material" firms have larger boards (*BOARD* -- mean of 11.45 members vs. 10.70 members), fewer insiders on the board of directors (*INSIDEDIR%* -- mean of 21 percent vs. 29 percent), lower stock ownership by insiders (*INSIDEOWN%* -- mean of 3 percent vs. 10 percent), larger audit committees (*AC_SIZE* -- mean of 4.52 members vs. 4.18 members), and a higher number of audit committees consisting solely of financial experts (*AC_EXPERT* -- mean of 26 percent vs. 13 percent). Substantially all firms in the sample were audited by the Big 4. These findings suggest that firms reporting ARO adjustments upon adoption of SFAS No. 143 have characteristics of stronger corporate governance.

Table 2

Descriptive Information and Differences in Reporting Upon Adoption of SFAS No. 143: 2003

	Material: N=104 [1]		Not Material N=282 [2]		
Variables	Mean	Median	Mean	Median	Difference in Means: [3] Sign & Significance
BOARD	11.45	11.50	10.70	11.00	+ **
INSIDEDIR%	0.21	0.18	0.29	0.27	- **
INSIDEOWN%	0.03	0.02	0.10	0.03	- **
AC_SIZE	4.52	4.50	4.18	4.00	+ **
AC_EXPERT	0.26	0.00	0.13	0.00	+ **
BIG4	1.00	1.00	0.98	1.00	+

*, ** Difference is statistically significant at $p < 0.05$ and < 0.01, respectively.

[1] Represents firms that recorded ARO adjustments upon adoption of SFAS No. 143 (see Table 1).

[2] Represents firms that did not record ARO adjustments upon adoption of SFAS No. 143 (see Table 1).

[3] Differences in means for the continuous variables *BOARD* through *AC_SIZE* are based on t-tests. Differences in the binary variables *AC_EXPERT* and *BIG4* are based on the Wilcoxon Rank-Sum (Z) Test.

Adoption of FIN 47

Fornaro and Huang (2012) suggest that the issuance of FIN 47 was a second attempt for companies to comply with the original provisions of SFAS No. 143. Table 3 presents descriptive information and tests of the differences for each variable upon adoption of FIN 47, partitioned between the 94 firms with an adjustment to the financial statements (material) and the remaining 292 firms (not material). The differences in means for each corporate governance variable are in the same direction and are statistically significant for the same five corporate governance variables as with SFAS No. 143. Specifically, "material" firms have larger boards, fewer insider board members, lower insider stock ownership, larger audit committees, and a higher number of audit committees consisting solely of financial experts.

Table 3

Descriptive Information and Differences in Reporting Upon Adoption of FIN 47: 2005

	Material: N=94 [1]		Not Material: N=292 [2]		Difference in Means: [3]
Variables	Mean	Median	Mean	Median	Sign & Significance
BOARD	11.30	11.00	10.88	11.00	+ *
INSIDEDIR%	0.18	0.14	0.22	0.20	- *
INSIDEOWN%	0.06	0.02	0.09	0.03	- *
AC_SIZE	4.49	4.00	4.24	4.00	+ *
AC_EXPERT	0.30	0.00	0.19	0.00	+ *
BIG4	1.00	1.00	0.98	1.00	+

*, ** Difference is statistically significant at $p < 0.05$ and $p < 0.01$, respectively.

[1] Represents firms that recorded ARO adjustments upon adoption of FIN 47 (see Table 1).

[2] Represents firms that did not record ARO adjustments upon adoption of FIN 47 (see Table 1).

[3] Differences in means for the continuous variables *BOARD* through *AC_SIZE* are based on t-tests. Differences in the binary variables *AC_EXPERT* and *BIG4* are based on the Wilcoxon Rank-Sum (Z) Test.

Noncompliance with SFAS No. 143 Adoption

As previously discussed, Table 1 provides evidence supporting the FASB's concerns over the lack of compliance with SFAS No. 143. More specifically, 94 firms recognized AROs under FIN 47 that should have been reported two years earlier. Of these 94 firms, 53 recognized adjustments in both 2003 *and* 2005. In other words, these 53 firms needed two attempts to comply with the original intent of SFAS No. 143. The remaining 41 firms (94 - 53) recorded cumulative adjustments only in 2005. This suggests that the corporate governance of firms with previously unreported AROs did not ensure adherence with the provisions of the principles-based standard.

Table 4 presents descriptive information and examines whether significant differences in corporate governance variables exist between firms that originally complied with SFAS No. 143 compared to noncompliant firms. The latter represents the 94 firms that reported additional AROs under FIN 47, partitioned into two groups: (1) the 53 firms that recorded AROs in *both* 2003 and 2005 (Group 1), and (2) the remaining 41 firms (94 - 53) that cumulatively recorded AROs only upon adoption of FIN 47 (Group 2). Compliant firms represent the 51 firms (104 - 53) that adopted SFAS No. 143 in 2003 and made no additional adjustments in 2005. Variables are based on 2003 data.

The findings in Table 4 indicate that the corporate governance variables were not statistically different between compliant firms and both groups of noncompliant firms. In other words, individual elements of corporate governance were essentially the same whether firms complied with SFAS No. 143 or not.

Table 4

Descriptive Information and Tests of Differences in ARO Adjustments Upon Adoption of SFAS No. 143 and FIN 47

	Compliant Firms		Noncompliant Firms					
	ARO Adjustments in 2003 Only: N=51 [1]		Group 1: ARO Adjustments in 2003 and 2005: N=53 [2]		Group 2: ARO Adjustments in 2005 Only : N=41 [3]		Difference in Means: [4]	
Variables	**Mean**	**Median**	**Mean**	**Median**	**Mean**	**Median**	**Compliant - Group 1**	**Compliant – Group 2**
BOARD	11.24	11.00	11.66	12.00	10.78	11.00	^	^
INSIDEDIR%	0.22	0.18	0.20	0.17	0.27	0.25	^	^
INSIDEOWN%	0.04	0.02	0.03	0.01	0.07	0.02	^	^
AC_SIZE	4.35	4.00	4.68	5.00	4.46	4.00	^	^
AC_EXPERT	0.22	0.00	0.30	0.00	0.22	0.00	^	^
BIG4	1.00	1.00	1.00	1.00	1.00	1.00	^	^

^ There is no statistically significant difference in the corporate governance variable between the groups.

[1] Represents 51 firms (104 - 53) that recorded ARO adjustments upon adoption of SFAS No. 143 in 2003 and no further adjustments in 2005 (see Table 1).

[2] Represents 53 firms that recorded ARO adjustments upon adoption of SFAS No. 143 in 2003 and FIN 47 in 2005 (see Table 1).

[3] Represents 41 firms (94 - 53) that recorded ARO adjustments only upon adoption of FIN 47 in 2005.

[4] Differences in means for the continuous variables *BOARD* through *AC_SIZE* are based on t-tests. Differences in the binary variables *AC_EXPERT* and *BIG4* are based on the Wilcoxon Rank-Sum (Z) Test.

Conclusion

The discussion of principles-based versus rules-based accounting standards has been ongoing for years. This article examines elements of corporate governance for a sample of *Fortune 500* firms at the time that a principles-based standard (SFAS No. 143) became effective. A large number of firms did not comply with the standard's underlying principles: some firms either delayed initial recognition of AROs until FIN 47 was issued, or recorded obligations under both SFAS No. 143 and FIN 47. Firms reporting ARO adjustments upon adoption of the standards appear to exhibit characteristics of stronger corporate governance, however, it does not appear that stronger corporate governance ensured compliance with the principles-based standard. This is important given the ongoing movement toward principles-based standards. In fact, the SEC is exploring whether existing prescriptive guidance in Regulation S-K should be replaced with a principles-based framework for financial disclosures (SEC, 2016). Accordingly, the need for even greater oversight by those responsible for corporate governance will be an essential factor for success in a principles-based accounting environment.

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