Principles-Based Approach in Accounting Standards and the Legal System: An Analysis of Comment Letters from U.S. Companies and Industrial Associations

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In 2002, the Financial Accounting Standards Board (FASB) published a proposal entitled Principles-Based Approach to U.S. Standard Setting. Subsequently, 70% of the comment letters submitted by U.S. companies and industrial associations were in favor of the proposal. The purpose of this study is to analyze the background and reasons why U.S. companies and industrial associations supported the proposal.

The results of this research showed that principles-based standards would enhance the responsiveness of accounting professionals to market changes and simplify international procedures. Moreover, when principles-based standards are applied, a higher degree of professional judgment is needed, and this approach then becomes an important factor in improving the status of accounting professionals in accounting standard setting. These are the positive reasons for which companies and industrial associations supported the FASB’s proposal.

As the principles-based approach tends to rely more on professional judgment, its use in accounting standards would increase substantially the scope of legal responsibility and subsequent risks for potential litigations. In response to such risks, this study points out that legal protections exist for corporate directors or officers, such as the business judgment rule, indemnification by companies, and limitations on damages. These laws and regulations tend to restrict or make corporate directors or officers exempt from their legal responsibilities in business decisions. In the context of the principles-based approach, the function of the regulatory system would become even more important.

In addition, these results have implications for how Japanese business law may handle the possibly litigious environment under the changes in the International Financial Reporting Standards (IFRS). The argument here is that the Japanese legal environment would be adequate to handle the possible increase in financial litigation, as is the legal environment in the United States.