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Christopher Nobes & Robert Parker

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COMPARATIVE INTERNATIONAL ACCOUNTING

Christopher Nobes

and

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Preface

Purpose

Comparative International Accounting is intended to be a comprehensive and coherent text on international financial reporting. It is primarily designed for undergraduate and postgraduate courses in comparative and international aspects of financial reporting. We believe that a proper understanding requires broad overviews (as in Part I), but that these must be supported by detailed information on real countries and companies (as in Parts II–IV) and across-the-board comparisons of major topics (as in Parts V and VI).

This book was first published in 1981. This present edition (the thirteenth) is a complete updating of the twelfth edition. For example, since the last edition, the following have occurred: Brazil, Russia and South Korea have adopted IFRSs; a number of Japanese companies have volunteered to adopt IFRS; the US has ended speculation that it would adopt IFRS soon; several options have been removed from IFRSs; a major new standard on revenue recognition has been issued jointly by the IASB and the FASB; the EU Directives have been amended; old UK GAAP has been abolished and replaced with a version of IFRS for SMEs; and much relevant academic literature has been published.

In addition to the extensive updating, we have also:

- expanded the material on IFRS/US convergence, in Chapters 5 and 8;
- expanded discussion of adoption of IFRSs in smaller countries, in Chapter 5;
- moved the still-relevant material on financial analysis into Chapter 5, and then deleted the old Chapter 21;
- referred to gaps in IFRSs and how they are filled by companies, in Chapter 6; and
- expanded the material on compliance and governance, in Chapter 20.

A revised manual for teachers and lecturers is available from http://www.pearsoned.co.uk/nobes. It contains several numerical questions and a selection of multiple-choice questions. Suggested answers are provided for all of these and for the questions in the text. In addition, there is now an extensive set of PowerPoint slides.

Authors

In writing and editing this book, we have tried to gain from the experience of those with local knowledge. This is reflected in the nature of those we thank below for advice and in our list of contributors. For example, the original chapter on North America was co-authored by a Briton who had been assistant research director of the US FASB; his knowledge of US accounting was thus interpreted through and for non-US readers. The amended version is by one of the editors, who has taught in several US universities. This seems the most likely way to highlight differences and

to avoid missing important points through overfamiliarity. The chapter on political lobbying is written by Stephen Zeff, an American who is widely acknowledged as having the best overview of historical and international accounting developments. The chapter on currency translation is written by John Flower, who has taught in UK universities but then worked in Brussels for the EU Commission, and now lives in Germany.

The two main authors have, between them, been employed in nine countries. Christopher Nobes currently holds university posts in Australia, Norway and the UK. Robert Parker, who retired from full-time university work in 1997, has now taken an advisory role rather than an executive one.

Structure

Part I sets the scene for a study of comparative international financial reporting. Many countries are considered simultaneously in the introductory chapter and when examining the causes of the major areas of difference (Chapter 2). It is then possible to try to put accounting systems into groups (Chapter 3) and to take the obvious next step by discussing the purposes and progress of international harmonization of accounting (Chapter 4).

All this material in Part I can act as preparation for the other parts of the book. Part I can, however, be fully understood only by those who become well informed about the contents of the rest of the book, and readers should go back later to Part I as a summary of the whole.

Part II examines financial reporting by listed groups. In much of the world this means, at least for consolidated statements, using the rules of either the International Accounting Standards Board or the United States. In addition to an overview and chapters on these two 'systems' of accounting, Part II also contains a chapter on whether national versions of IFRS exist, one that examines major accounting topics in a comparative IFRS/US way, and one on political lobbying about accounting standards.

Part III of the book deals with financial reporting in the world's second and third largest economies (China and Japan). They share much in common, including having Roman-based commercial legal systems and having requirements for the consolidated statements of listed companies that are separate from those for other types of reporting. Neither country directly imposes IFRSs or US GAAP, although the influences of those systems have been strong. It is therefore clearer to deal with these major countries (as we do in Chapter 11) separately from those countries using IFRSs or US GAAP.

Part IV concentrates on the point raised above: that many countries have separate national rules for unlisted companies or unconsolidated statements. Chapter 12 examines a number of issues relating to the context of reporting by individual companies, e.g. the relationship between accounting and tax. It also looks at the IFRS for SMEs. Chapters 13–15 concentrate on Europe, where the world's next three largest economies (after the US, China and Japan) are located. EU harmonization is studied in Chapter 13. Then, Chapters 14 and 15 look at the making of the rules for reporting by individual companies in France, Germany and the UK, and at the content and exercise of those rules.

Part V examines, broadly and comparatively, three major group accounting topics: consolidation, foreign currency translation and segment reporting. Part VI looks at two matters that come at the end of the financial reporting process: external auditing and enforcement of the rules.

At the end of the book, there is a synoptic table of accounting differences across eight GAAPs, a glossary of abbreviations relevant to international accounting, suggested answers to some chapter questions and two indexes (by author and by subject).

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Despite the efforts of all these worthies, errors and obscurities will remain, for which we are culpable jointly and severally.

Christopher Nobes
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University of Exeter

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Part I

SETTING THE SCENE

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OBJECTIVES

After reading this chapter, you should be able to:

- explain why international differences in financial reporting persist, in spite of the adoption of International Financial Reporting Standards (IFRS) by Australia, Brazil, Canada, the member states of the European Union and many other countries;
- illustrate the ways in which accounting has been influenced by world politics, the growth of international trade and foreign direct investment, the globalization of stock markets, varying patterns of share ownership, and the international monetary system;
- outline the nature and growth of multinational enterprises (MNEs);
- explain the historical, comparative and harmonization reasons for studying comparative international accounting.

1.1 Differences in financial reporting

If several accountants from different countries, or even from one country, are given a set of transactions from which to prepare financial statements, they will not produce identical statements. There are many reasons for this. First, the accounting rules may differ between countries and also within countries. In particular the rules for company groups may differ from the rules for individual companies. Multinational enterprises (MNEs) which operate as company groups in more than one country may find inter-country differences particularly irksome. Also, although all accountants follow a set of rules, no set covers every eventuality or is prescriptive to the minutest detail. Thus, there is always room for professional judgement, the exercise of which depends in part on the accountants' environments (e.g. whether or not they see the tax authorities as the main users of financial statements).

Awareness of these differences in financial reporting has led to impressive attempts to reduce them – in particular, by the International Accounting Standards Board (IASB) and by the European Union (EU). The IASB issues International Financial Reporting Standards (IFRS). The EU has issued Directives and Regulations. The importance of American stock markets and US-based MNEs has meant that US generally accepted accounting principles (GAAP) have greatly influenced rule-making worldwide. All this has certainly led to a lessening of international differences but, as this book will show, many still remain.

An example of the differences is provided by looking at the reports of GlaxoSmithKline (GSK), a large UK-based pharmaceutical company. GSK reported under UK GAAP until 2004, and used IFRS from 2005. GSK is listed in New York as well as on the London Stock Exchange, and in accordance with requirements of the US Securities and Exchange Commission (SEC) it had to provide up to 2006 reconciliations of its earnings and shareholders' equity to US GAAP. The differences, as disclosed in Tables 1.1 and 1.2, are startling. Data from other such reconciliations

Table 1.1 GlaxoSmithKline reconciliations of earnings to US GAAP

	UK £m	IFRS £m	US £m	Difference (% change)
1995	717		296	−59
1996	1,997		979	−51
1997	1,850		952	−49
1998	1,836		1,010	−45
1999	1,811		913	−50
2000	4,106		(5,228)	−227
2001	3,053		(143)	−105
2002	3,915		503	−87
2003	4,484		2,420	−46
2004	4,302		2,732	−36
2005		4,816	3,336	−31
2006		5,498	4,465	−19

Table 1.2 GlaxoSmithKline reconciliations of shareholders' equity to US GAAP

	UK £m	IFRS £m	US £m	Difference (% change)
1995	91		8,168	+8,876
1996	1,225		8,153	+566
1997	1,843		7,882	+328
1998	2,702		8,007	+196
1999	3,142		7,230	+130
2000	7,517		44,995	+499
2001	7,390		40,107	+443
2002	6,581		34,992	+432
2003	5,059		34,116	+574
2004	5,925		34,042	+475
2005		7,570	34,282	+353
2006		9,648	34,653	+259

are given later in this book. Not all are as extreme as those of GSK, but it is clear that the differences can be very large and that no easy adjustment procedure can be used. One reason for this is that the differences depend not only on the differences between two or more sets of rules, but also on the choices allowed to companies within those rules. The adoption of IFRS by listed companies within the EU from 2005 onwards, and greater convergence between those standards and US GAAP, has reduced – but not removed – these differences. Unfortunately, published reconciliations are unusual after 2006, so the size of the differences cannot be assessed so easily.

Understanding why there have been differences in financial reporting in the past, why they continue in the present, and will not fully disappear in the future, is one of the main themes of comparative international accounting. In the next two sections of this chapter, we look at the global environment of financial reporting, and in particular at the nature and growth of multinational enterprises. We then explore in more depth the reasons for studying comparative international accounting. In the last section we explain the structure of the book.

1.2 The global environment of accounting

1.2.1 Overview

Accounting is a technology which is practised within varying political, economic, and social contexts. These have always been international as well as national. Certainly since the last quarter of the twentieth century, the globalization of accounting rules and practices has become so important that narrowly national views of accounting and financial reporting can no longer be sustained.

Particularly important parts of the context have been:

- major political issues, such as the dominance of the United States and the expansion of the EU;
- economic globalization, including the liberalization of, and dramatic increases in, international trade and foreign direct investment;
- the emergence of global financial markets;
- patterns of share ownership, including the influence of privatization;
- changes in the international financial system;
- the growth of MNEs.

These developments are interrelated and all have affected financial reporting and the transfer of accounting technology from one country to another. They are now examined in turn.

1.2.2 Accounting and world politics

Important political events since the end of the Second World War in 1945 have included: the emergence of the United States and the Soviet Union as the world's two superpowers, followed by the collapse of Soviet power at the end of the 1980s; the break-up of the British and continental European overseas empires; and the creation of the EU, which has expanded from its original core of six countries to include, among others, the UK and many former communist countries. More detail on the consequences that these events have had for accounting is given in later chapters, particularly Chapters 4, 5, 11 and 13. The following illustrations may suffice for the moment:

- US ideas on accounting and financial reporting have been for many decades, and remain, the most influential in the world. The collapse of the US energy trading company, Enron, in 2001, and the demise of its auditor, Andersen, had repercussions in all major economies.
- The development of international accounting standards (at first of little interest in the US) owes more to accountants from former member countries of the British Empire than to any other source. The International Accounting Standards Committee (IASC) and its successor, the IASB, are based in London; the driving force behind the foundation of the IASC, Lord Benson, was a British accountant born in South Africa.
- Accounting in developing countries is still strongly influenced by the former colonial powers. Former British colonies tend to have Institutes of Chartered Accountants (set up after the independence of these countries, not before), Companies Acts and private sector accounting standard-setting bodies. Former French colonies tend to have detailed governmental instructions, on everything from double entry to published financial statements, that are set out in national accounting plans and commercial codes.
- Accounting throughout Europe has been greatly influenced by the harmonization programme of the EU, especially its Directives on accounting and, more recently, its adoption of IFRS for the consolidated financial statements of listed companies.

- The collapse of communism in Central and Eastern Europe led to a transformation of accounting and auditing in many former communist countries. The reunification of Germany put strains on the German economy such that large German companies needed to raise capital outside Germany and to change their financial reporting in order to be able to do so.

1.2.3 Economic globalization, international trade and foreign direct investment

A notable feature of the world economy since the Second World War has been the globalization of economic activity. This has meant the spreading round the world not just of goods and services but also of people, technologies and concepts. The number of professionally qualified accountants has greatly increased. Member bodies of the International Federation of Accountants (IFAC) currently have well over two million members. Accountants in all major countries have been exposed to rules, practices and ideas previously alien to them.

Much has been written about globalization and from many different and contrasting points of view. One attractive approach is the 'globalization index' published annually in the journal *Foreign Policy*. This attempts to quantify the concept by ranking countries in terms of their degree of globalization. The components of the index are: political engagement (measured, inter alia, by memberships of international organizations); technological connectivity (measured by internet use); personal contact (measured, inter alia, by travel and tourism and telephone traffic); and economic integration (measured, inter alia, by international trade and foreign direct investment). The compilers of the index acknowledge that not everything can be quantified; for example, they do not include cultural exchanges. The ranking of countries varies from year to year but the most globalized countries according to the index are small open economies such as Singapore, Switzerland and Ireland. Small size is not the only factor, however, and the top 20 typically also includes the US, the UK and Germany. A possible inference from the rankings is that measures of globalization are affected by national boundaries. How different would the list be if the EU were one country and/or the states of the US were treated as separate countries?

From the point of view of financial reporting, the two most important aspects of globalization are international trade and foreign direct investment (FDI) (i.e. equity interest in a foreign enterprise held with the intention of acquiring control or significant influence). Table 1.3 illustrates one measure of the liberalization and growth of international trade: merchandise exports as a percentage of gross domestic product (GDP). Worldwide, the percentage has more than trebled since the end of the Second World War. The importance of international trade to member states of the EU is particularly apparent; much of this is intra-EU trade. At the regional level, economic integration and freer trade have been encouraged through the EU and through institutions such as the North American Free Trade Area (NAFTA) (the US, Canada and Mexico). The liberalization has also been due to the dismantling of trade barriers through 'rounds' of talks under the aegis of the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organization (WTO). However, trade was under threat in 2008–9 for two connected reasons: (i) the 'credit

Table 1.3 Merchandise exports as a percentage of gross domestic product, 1950–98

	1950	1973	1998
France	7.7	15.2	28.7
Germany	6.2	23.8	38.9
Netherlands	12.2	40.7	61.2
United Kingdom	11.3	14.0	25.0
Spain	3.0	5.0	23.5
Brazil	3.9	2.5	5.4
Mexico	3.0	1.9	10.7
United States	3.0	4.9	10.1
China	2.6	1.5	4.9
India	2.9	2.0	2.4
Japan	2.2	7.7	13.4
World	5.5	10.5	17.2

Source: Based on data from Maddison, A. (2001), *The World Economy: A Millennial Perspective*, Development Centre Studies, OECD Publishing, Paris

crunch' and falling demand reduced trade; and (ii) rising unemployment led to calls for domestic industries to be protected against foreign imports.

One area in which trade is insufficiently liberalized is agricultural products, leading to the criticism that liberalization has benefited developed rather than developing countries. For a discussion of both the positive and negative aspects of international trade, see Finn (1996).

The importance of FDI is illustrated in Table 1.4, which ranks the ten leading MNEs by the size of their foreign assets. It also shows the percentages of their assets, sales and employees that are foreign, and a simple transnationality index (TNI), calculated as the average of the percentages. The home countries of these MNEs are the UK (three MNEs), the US (three), France, Germany, Italy and Japan (one each). The industries represented are oil (six MNEs), motor vehicles (two), electrical equipment (one) and telecommunications (one). Vodafone, Total and Shell have the highest transnationality indices. Of course, the very nature of an MNE means that the concept of a 'home country' can be ambiguous. For example, in Table 1.4, we show Royal Dutch Shell plc as a UK company, as in the source of the data. The company is, indeed, incorporated in England and Wales. However, here are some other facts about it:

- the word 'Dutch' (and the 'Royal' which relates to the Netherlands not the UK) reflect a former merger;
- its head office is in the Netherlands, as is its tax residency;
- it is listed on stock exchanges in Amsterdam, London and New York;
- it presents its financial statements in US dollars;
- it has operations in 90 countries and shareholders all over the world.

Table 1.4 World's top ten non-financial multinationals ranked by foreign assets, 2013

Company	Country	Industry	Foreign assets (US $bn)	% that is foreign of Assets	Sales	Employees	TNI
General Electric	US	Electrical	331	50	52	44	49
Royal Dutch Shell	UK	Oil	302	84	61	73	73
Toyota Motor	Japan	Motors	274	68	67	41	57
Exxon Mobil	US	Oil	231	67	67	60	63
Total	France	Oil	227	95	77	66	80
BP	UK	Oil	202	66	66	77	70
Vodafone	UK	Telecoms	182	90	85	91	89
Volkswagen	Germany	Motors	176	40	81	55	59
Chevron	US	Oil	175	69	58	50	59
Eni	Italy	Oil	141	74	72	67	71

Note: TNI = transnationality index, calculated as an average of the assets, sales and employees percentages.
Source: Compiled by the authors from data in UNCTAD (2014) *World Investment Report 2014*.

Despite this interesting mix, its choice of England as country of incorporation has some major effects, such as:

- the annual report is presented under UK law;
- the auditors (pwc, London) are appointed under UK law;
- the calculation of distributable profit is done under UK law; and
- the UK corporate governance code is followed.

1.2.4 Globalization of stock markets

At the same time as international trade and FDI have increased, capital markets have become increasingly globalized. This has been made possible by the deregulation of the leading national financial markets (e.g. the 'Big Bang' on the London Stock Exchange in 1986, and the similar event in Japan in 1998); the speed of financial innovation (involving new trading techniques and new financial instruments of sometimes bewildering complexity); dramatic advances in the electronic technology of communications; and growing links between domestic and world financial markets. Table 1.5 lists the countries where there are stock exchanges with more than 500 domestic listed companies and also a market capitalization (excluding investment funds) of more than US$1,000 billion. Of the five BRICS countries (Brazil, Russia, India, China and South Africa), only China and India are represented.

Davis *et al.* (2003) examine the international nature of stock markets from the nineteenth century onwards, and chart the rise in listing requirements on the London, Berlin, Paris and New York exchanges. Michie (2008) also provides an international history of stock markets. Precise measures of the internationalization of the world's stock markets are hard to construct. Two crude measures are cross-border listings and the extent to which companies translate their annual reports into other languages for

Table 1.5 Major stock exchanges, January 2015

Country	Exchange	Domestic listed companies	Market capitalization of domestic equities ($bn)	Market capitalization as % of NYSE
Europe				
–	Euronext	935	3,319	17
Germany	Deutsche Börse	595	1,739	9
United Kingdom	London	2,429*	4,095*	21
The Americas				
Canada	Toronto	3,691	2,094	11
United States	NASDAQ	2,430	6,979	36
	New York	1,939	19,351	100
Asia-Pacific				
China	Hong Kong	1,661	3,233	17
	Shanghai	995	3,933	20
	Shenzhen	1,618	2,072	11
India	Bombay	5,541	1,588	8
Japan	Tokyo	3,348	4,378	23
South Korea	Seoul	1,708	1,213	6
Australia	Australian	1,967	1,289	7

Source: Prepared using data from World Federation of Exchanges.
*However, the London figures are not recorded in that source, so they might not be fully comparable.

the benefit of foreign investors. For example, French companies have been listed on stock exchanges in Australia, Belgium, Canada, Germany, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US (Gélard, 2001, pages 1038–9).

Until the middle of the 2000s, the New York Stock Exchange had the largest number of foreign listed companies, who thereby got access to the world's largest capital market. However, New York became less popular because of heavier regulation, such as the Sarbanes-Oxley Act and US GAAP itself (see Part II of this book). Table 1.6 shows the new equity listings and de-listings of foreign companies on the exchanges with the largest number of new listings in 2009. Before the turbulence of 2008 and onwards, London had headed the table of listings. In 2009, there was a net de-listing on both London and New York exchanges.

Table 1.7 shows the extent of listing by foreign companies on the world's major stock exchanges (mostly those in Table 1.5) by early 2011. The largest number of foreign listings is no longer on the New York Stock Exchange but on London. The fall in popularity of New York is part of the political background to the acceptance by the SEC of IFRS statements from foreign registrants from 2007. The virtual lack of foreign listings in Tokyo (the world's third largest stock exchange) and Toronto is very apparent. To find the exchanges with the largest percentages of foreign listings, we must go beyond Table 1.5 to smaller but open economies: in Luxembourg, 90 per cent of the 288 listings were foreign; in Singapore, 41 per cent of 782.

Table 1.6 Top twelve exchanges for new equity listings in 2009

	Listings	De-listings
Mexican	42	9
New York	36	43
London	26	98
Luxembourg	26	21
NASDAQ	17	33
Singapore	10	12
Taiwan	10	0
Australian	7	7
Korean	6	0
Toronto	5	12
Euronext	5	9
Johannesburg	5	4

Source: Compiled from the 2009 Annual Statistics of the World Federation of Exchanges.

Table 1.7 Foreign company listings on major stock exchanges, January 2011

	Number	As % of total listings
London	600	20
New York	520	22
NASDAQ	299	11
Euronext	153	14
Toronto	89	2
Australia	88	4
Germany	79	10
Hong Kong	17	1
Tokyo	12	0
Brazil	8	2
Bombay	0	0
Shanghai	0	0

Source: Prepared using data from World Federation of Exchanges.

Any particular company might be listed on many exchanges. For example, the 2000 annual report of Volvo, the Swedish commercial vehicle company, discloses listings on the exchanges of five foreign countries; but in 2007 there was only one: the US (the NASDAQ); and by the 2008 annual report the NASDAQ and the Swedish exchange (OMX) had merged, so there was only one listing. Norsk Hydro, the Norwegian power company, listed on seven foreign exchanges in 2000, reduced to the US, UK, Euronext and Germany in 2008; and then to only London by 2011.

The above two are very large companies based in rather small countries, which suggests one of the main reasons for foreign listing: to attract extra investors and widen the pool of shareholders. For example, Norsk Hydro reported in 2014 that 9 per cent of its shares are owned by US shareholders and another 9 per cent by UK

shareholders. Gray *et al.* (1994) look at foreign listings of several large European companies. Saudagaran (1988) found evidence that a company's size relative to its domestic exchange helps to explain foreign listings.

Another reason for foreign listing is that the company wishes to raise its profile in a foreign country among potential customers, employees or regulators. The first listing of a German company on a US exchange (Daimler-Benz in 1993) was related to the setting up of factories in the US and the expansion of sales. Radebaugh *et al.* (1995) look in more detail at this particular case. It was followed by a takeover of the US car company, Chrysler, which was presented as a 'merger of equals' for public relations and accounting reasons (see Section 8.7.2).

Of course, as well as potential benefits from foreign listing, there are also costs. These include the expenses of initially satisfying the accounting and other requirements of the foreign exchange or its regulator, and then the continuing need to provide extra or different accounting compared to domestic requirements. Biddle and Saudagaran (1989) found evidence of resistance to extra disclosures by MNEs from eight countries (including the UK), although Gray and Roberts (1997) found no such evidence for UK companies. The world's largest equity markets are based in New York, including the New York Stock Exchange and NASDAQ. These exchanges have their own requirements but the major problem for companies wishing to list on them is to satisfy the requirements of the Securities and Exchange Commission (SEC), including the onerous auditing and corporate governance requirements of the Sarbanes-Oxley Act. Foreign registrants can present full-scale US GAAP annual reports but generally they choose instead to file Form 20-F, which contains many of the normal SEC-required disclosures but allows, from 2007, IFRS (as issued by the IASB) to be used. Otherwise, foreign registrants file Form 20-F using domestic accounting with numerical reconciliations to US GAAP for equity and income. This was the normal route for most until 2007.

If a non-US company wishes to gain access to US markets without so much cost, it can arrange for its shares to be traded 'over the counter' (not fully listed) through American Depositary Receipts (ADRs). The ADRs (which contain a package of shares) are traded, rather than the shares themselves. The SEC then accepts domestic annual reports without reconciliation to US GAAP. It is also possible to arrange for ADRs to be traded on an exchange but then reconciliation is necessary.

Some companies publish their annual reports in more than one language. The most important reason for this is the need for large MNEs to raise money and have their shares traded in the US and the UK. This explains why English is the most common secondary reporting language. Jeanjean *et al.* (2010) examine various reasons that explain why translation into English is more common in some countries than in others.

Other reasons for using more than one language may be that the MNE is based in a country with more than one official language, that the MNE has headquarters in more than one country or that it has substantial commercial operations in several countries. For example, the Finnish telecommunications company, Nokia, published its annual report and financial statements not only in Finnish and Swedish (the two official languages of Finland) but also in English. The Business Review section of the report was also available in French, German, Italian, Portuguese, Spanish, Chinese and Japanese (Parker, 2001b). Evans (2004) discusses the problems of

translating accounting terms from one language to another. Baskerville and Evans (2011) report on the difficulties of translating IFRS, as discovered by conducting a survey of translators.

A more sophisticated measure of internationalization is the extent to which stock markets have become 'integrated', in the sense that securities are priced according to international rather than domestic factors (Wheatley, 1988). Froot and Dabora (1999) show that domestic factors are still important even for such Anglo-Dutch 'twin' stocks as Unilever NV/PLC. Figge and Martens (2014) discuss new globalization indices.

National stock exchange regulators not only operate in their domestic markets but also are – through the international bodies to which they belong, such as the International Organization of Securities Commissions (IOSCO) and the European Securities and Markets Authority (ESMA) – playing increasingly important roles in the internationalization of accounting rules (see Chapter 4).

1.2.5 Patterns of share ownership

The globalization of stock markets does not mean uniformity of investor behaviour around the world. Patterns and trends in share ownership differ markedly from country to country. The nature of the investors in listed companies has implications for styles of financial reporting. The greater the split between the owners and managers of these companies, the greater the need for publicly available and independently audited financial statements. La Porta *et al.* (1999) distinguish companies whose shares are widely held from those that are family controlled, state controlled, controlled by a widely held financial corporation or controlled by a widely held non-financial corporation. According to their data, which covered 27 countries (not including China, India and Eastern Europe) in the mid-1990s, 36 per cent of the companies in the world were widely held, 30 per cent were family controlled and 18 per cent were state controlled. The countries whose largest 20 companies were most widely held were, in descending order, the UK, Japan, the US, Australia, Ireland, Canada, France and Switzerland. The countries with most family control were Mexico, Hong Kong and Argentina. The countries with most state control were Austria, Singapore, Israel, Italy, Finland and Norway. The countries with companies held 15 per cent or more by a widely held financial corporation were Belgium, Germany, Portugal and Sweden.

More up-to-date data are available from surveys of share ownership. These show different trends in different countries. In the US the percentage of households investing in shares and bonds directly or indirectly grew rapidly from 1989 onwards, peaking at 50 per cent in 2001, but falling to 47 per cent by 2008 (Investment Company Institute *et al.*, 2008). In the UK at the end of 2006, foreign investors held 40 per cent of shares, insurance companies 15 per cent, pension funds 13 per cent, individuals 13 per cent, other financial institutions 10 per cent and banks 3 per cent. The percentage held by foreign investors has been steadily increasing (National Statistics, 2007). Some reasons for this are: international mergers where new companies are listed in the UK; the flotation of UK subsidiaries of foreign companies in which the foreign parent retains a significant stake; and companies moving their domicile to the UK. More data on this are presented in Section 2.4, where the implications for accounting are discussed.

Privatization, i.e. the selling-off of state-owned businesses, has greatly expanded the private sector in many countries. In the UK, for example, the privatization of public utilities and other publicly owned enterprises from the 1980s onwards brought several very large organizations within the ambit of company law and accounting standards. In the short run this increased the number of shares held by persons, but many of them later sold out and some companies have deliberately tried to reduce the number of their small shareholders. Privatization opened companies up to foreign ownership, thus stimulating the growth of FDI, and facilitating their expansion into foreign markets. Privatization has been most dramatic in the former communist countries of Central and Eastern Europe. In some cases, notably in Russia, privatization has transferred the ownership of large companies from the state to a small group of so-called 'oligarchs'. In 2008, many governments around the world reluctantly bought shares in financial institutions in order to rescue them. So, privatization went, at least temporarily, into reverse.

Having looked above at why a company might seek foreign investors, we now look at why an investor might seek foreign opportunities to invest. It is easy, looking backwards, to identify countries where shares have risen more rapidly than in one's own country over the last one, five or ten years. This would argue for overseas investment if the past were a good predictor of the future. Even if it is not, a large investor might wish to diversify among several countries because share price movements in different regions of the world are not strongly correlated. Gross annual purchases by foreigners of US securities in 2000 amounted to $7 trillion; and purchases by US residents of foreign securities were about half that. These figures had grown by about ten times over the previous ten years (Griever *et al.*, 2001).

Nevertheless, Lewis (1999) reports that investors in Europe, Japan and the US put only about 10 per cent of their investments into foreign shares, which is far below what one would expect if they considered foreign shares to be perfect substitutes for domestic ones. Choi and Levich (1990) looked at investors from the US, Japan and Europe and found that many were dissuaded from foreign investment by concern about different accounting practices. Others were put to extra expense in order to adjust the foreign statements. Later, Choi and Levich (1996) found that only about a quarter of European investors were restrained by international accounting differences. Miles and Nobes (1998) found that London-based investors did not generally adjust for the accounting differences.

Other reasons for home country bias could include currency risk, political risk, language barriers, transaction costs and taxation. Coval and Moskovitz (1999) found that investment managers show regional preferences even within the United States. On a related matter, Helliwell (1998) reported that Canadians are more than ten times more likely to trade with each other than with the US.

1.2.6 The international financial system

From 1945 to 1972, the international monetary system under the Bretton Woods Agreement was based on fixed exchange rates with periodic devaluations. From 1973, major currencies have floated against each other and exchange rates have been very volatile (as illustrated in Table 17.1). Within the EU, however, most national currencies, with the notable exception of the pound sterling, were replaced by a single

currency, the euro, in 1999. Accounting standard-setters have been much concerned with hedging activities and other transactions in foreign currency. There is discussion of these issues in Chapters 9 and 17.

In 2008 and 2009, the world's financial system was under exceptional stress. The collapse of financial institutions and whole economies led to calls for a new version of Bretton Woods. It also put the regulation of stock markets in the spotlight. The use of market values in accounting was criticized, partly because values were falling (causing losses to be revealed) and partly because markets were not operating so that a market price was difficult to determine. Academic writers conclude that accounting is not to blame (André *et al.*, 2009; Barth and Landsman, 2010).

1.3 The nature and growth of MNEs

MNEs may be broadly defined as those companies that produce a good or a service in two or more countries. 'MNE' is an economic category, not a legal one. The size of most MNEs is such that they need to raise external finance and hence need to be incorporated companies listed on stock exchanges. As listed companies (i.e. whose shares are publicly traded), their financial reporting is subject to special regulations that are discussed at length in Part II of this book. The existence of MNEs brought a new dimension to areas such as auditing, which already existed at the domestic level (see Chapter 19). Issues such as the translation of the financial statements of foreign subsidiaries for the preparation of consolidated statements (see Chapter 17) are peculiar to multinational companies. Most of the world's MNEs produce consolidated financial statements in accordance with either IFRS or US GAAP.

The above definition of MNEs is broad enough to include early fourteenth-century enterprises such as the Gallerani company, a Sienese firm of merchants that had branches in London and elsewhere, and whose surviving accounts provide one of the earliest extant examples of double entry (Nobes, 1982). From the late sixteenth century onwards, chartered land and trading companies – notably the English, Dutch and French East India Companies – were early examples of 'resource-seeking' MNEs, i.e. those whose object is to gain access to natural resources that are not available in the home country. The origins of the modern MNE are to be found in the period 1870 to 1914, when European people and European investment were exported on a large scale to the rest of the world and when the United States emerged as an industrial power. On the eve of the First World War, the stock of accumulated FDI was greatest in, by order of magnitude, the United Kingdom, the United States, Germany, France and the Netherlands. Two world wars decreased the relative economic importance of European countries and increased that of the United States. Table 1.8 shows how the rankings changed from 1914 to 2009. After the Second World War, the United States became, as it remains, the world's largest exporter of FDI. More recently, however, Europe-based multinationals have regained some of their relative importance and both US and European MNEs were challenged, at least for a time, by those of Japan. All these countries are major recipients of FDI as well as providers of it. A few other European countries are now also important holders of FDI.

Table 1.8 Percentage shares of estimated stock of accumulated foreign direct investment by country of origin, 1914–2009 (%)

	1914	1938	1980	1990	2000	2009
United Kingdom	45	40	15	13	14	9
United States	14	28	42	24	20	23
Germany	14	1	8	8	8	7
France	11	9	5	6	7	9
Netherlands	5	10	8	6	5	4
Japan	–	–	4	11	4	4

Sources: Based on Dunning (1992) and UNCTC (2010).

MNEs can be classified according to their major activity. Most nineteenth-century and earlier multinationals were 'resource-seeking'. In the twentieth century other types have developed. Some MNEs are 'market-seeking', i.e. they establish subsidiaries whose main function is to produce goods to supply the markets of the countries in which they are located. Other MNEs are 'efficiency-seeking', i.e. each subsidiary specializes in a small part of a much wider product range, or in discrete stages in the production of a particular product. Manufacturing MNEs have also developed subsidiaries that specialize in trade and distribution, or in providing services such as insurance, banking or finance. Some MNEs, such as the larger banks and accountancy firms, provide services on a global basis. Improvements in technology have led to the creation of overseas subsidiaries specializing in information transfer.

The extent to which the production of goods and services has been internationalized varies between countries and industries. The United States has the world's highest absolute value of FDI, but the size of its economy is such that investment overseas is relatively less important for the United States than for many European countries, although it is higher in percentage terms than that of Japan (see Table 1.9). Table 1.10 demonstrates the extent to which the headquarters of the largest 100 MNEs are located in the US and Europe. However, including slightly smaller companies, by looking at the Fortune 500 ranking (which is based on turnover rather than market capitalization), the number for China increased from 46 companies in 2010 to 95 companies in 2014. This was second only to the United States.

Economists and others have sought to explain why MNEs exist. The most favoured explanation is Dunning's eclectic paradigm, which states that the propensity for firms of a particular country to engage in, or to increase, overseas production is determined by three interrelated conditions. These are the extent to which the enterprises possess, or can gain privileged access to, assets that provide them with a competitive advantage over local firms; the extent to which relative transaction costs make it appropriate for the enterprises to use such advantages themselves rather than to license or franchise them to other firms; and the extent to which relevant costs and government policies push enterprises towards locating production overseas rather than towards meeting demand by exports from the home country. An important consequence of the growth of multinational enterprise is that much of the world's trade takes place within firms as well as between countries. The prices at which the

Table 1.9 Accumulated stock of outward foreign direct investment as a percentage of GDP in 2005 (selected countries)

Country	%
Norway	123
Switzerland	107
Belgium	104
Netherlands	103
Sweden	57
United Kingdom	56
France	41
Canada	35
Germany	35
Italy	17
United States	16
Japan	9
World	24

Source: United Nations Conference on Trade and Development (UNCTAD) (2007) *World Investment Report 2007: Transnational Companies Extractive Industries and Development*. Geneva UNCTAD. Copyright © United Nations 2007. Reproduced with permission.

Table 1.10 Share of the world's top 100 MNEs by market capitalization, 2014

United States		47
Europe:		
UK	9.5	
Germany	7	
France	5	
Spain	2	
Belgium	1	
Denmark	1	
Italy	1	
Netherlands	0.5	
Total EU	27	
Switzerland	3	
Norway	1	
Total Europe		31
China		6
Australia		4
Brazil		2
Canada		2
Hong Kong		2
Japan		2
Russia		1
Saudi Arabia		1
South Korea		1
Taiwan		1
		100

Source: Prepared by the authors from *FT Global 500*.

transactions take place are internal transfer prices, which are often not the same as open market prices. This has important implications for taxation, management control and the relationships between MNEs and their host countries.

The rise of the MNE is one of the main factors responsible for the internationalization of the accountancy profession. Accountancy firms have followed their clients around the world, setting up new offices overseas and/or merging with overseas firms. The audit of MNEs is considered further in Chapter 19.

1.4 Comparative and international aspects of accounting

Given the global context set out above, there are clearly strong arguments for studying international accounting. Moreover, there are at least three reasons why a comparative approach is appropriate. First, it serves as a reminder that the US and other Anglo-Saxon[1] countries are not the only contributors to accounting as it is practised today. Secondly, it demonstrates that the preparers, users and regulators of financial reports in different countries can learn from each others' ideas and experiences. Thirdly, it explains why the international harmonization of accounting has been deemed desirable but has proved difficult to achieve (Parker, 1983). These three reasons are now looked at in more detail.

Historically, a number of countries have made important contributions to the development of accounting. The Romans had forms of bookkeeping and the calculation of profit, although not double entry. In the Muslim world, while Christian Europe was in the Dark Ages, developments in arithmetic and bookkeeping paved the way for later progress. In the fourteenth and fifteenth centuries, the Italian city states were the leaders in commerce, and therefore in accounting. The 'Italian method' of bookkeeping by double entry spread first to the rest of Europe and eventually round the whole world. One lasting result of this dominance is the number of accounting and financial words in English and other languages that are of Italian origin. Some examples in English are bank, capital, cash, debit, credit, folio and journal.

In the nineteenth century, Britain took the lead in accounting matters, to be followed in the twentieth century by the United States. As a result, English has become established as the world's language of accounting (Parker, 2001a). Table 1.11, which gives details of some members of IFAC, shows, inter alia, that the modern accountancy profession developed first in Scotland and England. The table also shows that some countries (e.g. Australia, Canada and the UK) have more than one important accountancy body. A multiplicity of bodies has been the norm in Anglo-Saxon countries. The largest body is the American Institute of Certified Public Accountants.

Table 1.11 does not show rates of growth; the Chinese Institute of Certified Public Accountants has grown in recent years to become the fourth largest in the world.

[1]This expression is used in this book with its common European meaning, i.e. the UK, the US and other mainly English-speaking countries such as Canada, Australia and New Zealand.

Table 1.11 Age and size of some members of IFAC

Country	Body	Founding date*	Approx. members 2015 (000s)
Australia	CPA Australia	1952 (1886)	150
	Chartered Accountants Australia and New Zealand	2014 (1885)	100
Brazil	Conselho Federal de Contabilidade	1946	292**
Canada	Chartered Professional Accountants Canada	2013 (1880)	185
China	Chinese Institute of Certified Public Accountants	1988	203
France	Ordre des Experts Comptables	1942	19**
Germany	Institut der Wirtschaftsprüfer	1932	13**
India	Institute of Chartered Accountants of India	1949	162**
Japan	Japanese Institute of Certified Public Accountants	1948 (1927)	26‡
Netherlands	Koninklijk Nederlandse Beroepsorganisatie van Accountants	2013 (1895)	20
United Kingdom and Ireland	Institute of Chartered Accountants in England and Wales	1880 (1870)	144
	Institute of Chartered Accountants of Scotland	1951 (1854)	20
	Association of Chartered Certified Accountants	1939 (1891)	170
	Chartered Institute of Management Accountants	1919	100
	Chartered Accountants Ireland	1888	23
United States	American Institute of Certified Public Accountants	1887	401

*Dates of earliest predecessor bodies in brackets. The names of some of the bodies have changed from time to time.
**These numbers relate to 2011.
‡Excluding junior CPAs.

The table also does not show the extent to which bodies have worldwide and not just national membership. Two UK-based bodies, the Association of Chartered Certified Accountants (ACCA) and the Chartered Institute of Management Accountants (CIMA), have been notably active and successful in this regard. A look at the table also suggests that some countries have far more accountants per head of population than others. For example, in 2011 when separate numbers were available for New Zealand, the position was: France (population 60 million; accountants 19,000) and New Zealand (population 4 million; accountants 32,000). In other words, there were about 25 times as many accountants per million of population in New Zealand. Of course, comparisons such as these depend in part on how the term 'accountant' is defined in each country. There is further discussion of the accountancy profession in Chapter 2.

Table 1.12 demonstrates the overwhelmingly British and American origins of the largest international accountancy firms. Accounting techniques, institutions and concepts have been imported and exported around the world. Britain, for example, not only has imported double entry from Italy and exported professional accountancy to the rest of the world, but also has exported the concept of a true and fair view, first to the other countries of the British Commonwealth and, more recently, to the other member states of the EU (Parker, 1989; Nobes, 1993). The concepts and practices of management accounting throughout the industrialized world owe much to American initiatives. In the second half of the twentieth century, Japan contributed to management accounting and control. Carnegie and Napier (2002) make a persuasive case for the study of comparative international accounting *history*.

The second reason for taking a comparative approach is that it allows one to learn from both the achievements and failures of others and to avoid the perils of accounting ethnocentrism. It is possible for a country to improve its own accounting by observing how other countries react to problems that, especially in industrialized nations, may not differ markedly from those of the observer's home country. It is also possible to examine whether, where accounting methods differ, the differences are justified by differences in the economic, legal and social environment and are not merely the accidents of history. Such accidents may not impede harmonization (see Section 2.6), whereas more fundamental differences are likely to be much more difficult to deal with.

A feature of recent decades has been the extent to which countries have been willing to adopt and adapt accounting methods and institutions from other countries. Examples will be found in many of the chapters of this book. The UK accepted continental European ideas about greater uniformity in the layout of financial statements. France and Germany accepted US and UK approaches to consolidated statements. The Netherlands accepted a much greater degree of regulation of company accounting and auditing than previously. France and Australia set up their own versions of the US Securities and Exchange Commission (SEC). Germany, where enforcement of accounting standards had been weak, adopted a compromise between the SEC and the UK Financial Reporting Review Panel. Even the US, shaken by accounting scandals from 2001 onwards, is showing itself willing to consider the virtues of the principles approach to accounting standard setting espoused in the UK and by the IASB.

The third reason for taking a comparative approach is to better understand harmonization, a process that has grown steadily in importance since the 1970s. The

Table 1.12 Leading international accountancy firms, 2016

	Main countries of origin
Deloitte	UK, USA, Canada, Japan
EY (Ernst & Young)	USA, UK
KPMG	Netherlands, UK, USA, Germany
PwC (PricewaterhouseCoopers)	UK, USA

Note: The names given above are those of the international firms. National firms may have different names.

arguments for and against are considered in Chapter 4. As demonstrated later in this book, major problems such as lease accounting, consolidation accounting and foreign currency translation have been tackled in different countries in significantly different ways, although a pattern may sometimes be discerned. Solutions devised by the Financial Accounting Standards Board (FASB) in the US – the world's most powerful national accounting standard-setting body – have been very influential but have not always been accepted. Indeed, one reason for the acceptance by many countries and companies of international standards is that they are not US GAAP.

The growing strength of the IASB and the adoption of its standards by the EU (in part in order to prevent EU-based MNEs adopting US GAAP) can be seen as a process of regulatory competition (Esty and Geradin, 2001), with the IASB and the FASB competing in a 'race to the top'. The process of harmonization within the EU meant that all the major countries had their own regulatory solutions challenged and had to accept compromises of both a technical and a political nature. It is clear that any attempt to harmonize financial reporting touches on wider issues than accounting. In Chapter 2 we look at some of the underlying reasons for the differences that exist. Before that, we explain the structure of this book.

1.5 Structure of this book

1.5.1 An outline

The book is divided into six parts:

- Part I sets the context, covering the causes and nature of differences in financial reporting, classification of accounting systems, and an introduction to international harmonization.
- Part II deals with financial reporting by listed groups, which is dominated worldwide by IFRS and US GAAP.
- Part III looks at financial reporting in China and Japan.
- Part IV covers the financial reporting that continues to be governed by sets of national rules (particularly that by individual legal entities in Europe), some of which differ considerably from IFRS and US GAAP.
- Part V examines some major technical accounting issues related to group reporting by MNEs.
- Part VI looks internationally at auditing and enforcement.

The chapters in the six parts of the book are described in more detail below.

1.5.2 Part I: Setting the scene

The adoption of IFRS by the EU and the convergence of IFRS and US GAAP, both formally agreed in 2002, have not removed the differences in financial reporting among countries. This is partly because IFRS is used in many countries only for consolidated statements, and partly because different national versions of IFRS practice exist. The

causes and nature of these differences are discussed in Chapter 2. Several writers on international accounting have attempted classifications of financial reporting. These are discussed and evaluated in Chapter 3. Most classifications have been of countries, which are explicitly or implicitly assumed to have homogeneous financial reporting. More recently, the emphasis has shifted to 'accounting systems', in recognition of the fact that countries (and even companies) can use more than one type of accounting. In this book, we discuss differences between countries, between systems and between companies. This examination of international differences and patterns in them leads to Chapter 4, which introduces international harmonization, explaining why and how the need for this has grown in recent decades. We particularly look at the extent to which the need has been met by the IASC and its successor the IASB.

1.5.3 Part II: Financial reporting by listed groups using IFRS or US GAAP

Chapter 5 follows on from the material of Chapter 4 by exploring the relationship between international and national standards, including 'competition' and 'convergence' between IFRS and the most influential set of national standards, US GAAP. The chapter also introduces the analysis of financial statements in an international context. The requirements of IFRS are summarized in Chapter 6, first in terms of topics (conceptual framework, assets, liabilities, group accounting, disclosures) and secondly in the numerical order of extant standards. Chapter 7 examines the possible motives and opportunities for different national versions of IFRS practice. Chapter 8 describes and analyzes corporate financial reporting and its environment in the US, and includes a comparison of US rules with international rules. Chapter 9 examines some major topics of financial reporting by comparing IFRS and US GAAP. We leave issues specifically related to consolidation for later (Chapter 16). The setting of accounting rules is in part a political issue, and Chapter 10 therefore examines the politicization of accounting and particularly political lobbying by preparers of financial statements.

1.5.4 Part III: China and Japan

Chapter 11 compares and contrasts financial reporting in the two major countries of East Asia: China and Japan. These have the world's second and third largest economies. Both countries have been and still are subjected to a variety of outside influences, but both retain their own special national characteristics. Neither country requires the use of IFRS or US GAAP, but they have been heavily influenced by those accounting systems. The chapter examines accounting by both listed and unlisted companies, and accounting for both individual companies and groups.

1.5.5 Part IV: Financial reporting by individual companies

Financial reporting by individual business enterprises is much more diverse than that of listed company groups. Chapter 12 explains why this is the case, with special emphasis on the information needs of tax authorities and the determination of distributable profit. This chapter also examines the IFRS for small and medium enterprises (SMEs). Chapter 13 looks at the attempts that have been made to harmonize

the great variety of financial reporting that exists within the EU, as part of a more general aim of eliminating economic barriers. The chapter explains the initial difficulties of reconciling Continental European and Anglo-Saxon approaches, and the more recent problems of the accession to the EU of many economies which had to make a transition from communist to market-based accounting. Chapter 14 analyzes the different ways of rule-making that have evolved in Europe (accounting plans, legal codes, statutes, standards) and assesses their usefulness. Chapter 15 explains how the accounting rules applicable to individual business enterprises may differ from IFRS or US GAAP, with particular reference to France, Germany and the UK which have the next three largest economies after the US, China and Japan.

1.5.6 Part V: Group accounting issues in reporting by MNEs

Accounting standards are always in a state of change, and those contained within IFRS and US GAAP are no exception. It is never sufficient merely to learn the detailed content of standards at a particular date. All standards are compromises and this is especially so when they have to be agreed at an international level. Chapters 16–18 examine three problems which relate especially to MNEs: consolidated financial statements, foreign currency translation and segment reporting, with comparisons of the solutions arrived at in IFRS and US GAAP.

1.5.7 Part VI: Monitoring and enforcement

This Part looks at the final stages in the process that leads from transactions to bookkeeping to financial reporting to auditing and eventually to monitoring/enforcement. Chapter 19 explains how auditing has been internationalized, with particular reference to the role of MNEs, international capital markets, international accounting firms and IFRS. It looks at international standards on auditing (ISAs), the international audit process in practice and the audit expectations gap in an international context. Chapter 20 discusses how the application of IFRS and US GAAP to the financial statements of listed groups is governed and enforced in the US, in leading member states of the EU (UK, France and Germany), and in other important countries such as Australia, China and Japan.

SUMMARY

- The scale of international differences in corporate financial reporting remains large, despite the adoption of IFRS for listed companies within the EU and elsewhere.
- Financial reporting since the Second World War has taken place within a global context, which has been characterized by: vast changes in world politics; dramatic growth in international trade and FDI; the globalization of stock markets; varying patterns of share ownership; an unstable international monetary system; and the rise of MNEs, which are the main exporters and importers of FDI and a major factor in the internationalization of the accountancy profession.

- Historically, several countries have made important contributions to the development of accounting and financial reporting.
- The comparison of accounting rules and practices between countries is a strong antidote to accounting ethnocentrism. Successful innovations in one country are being copied in others.
- Harmonization is taking place at both regional and international levels.
- This book is arranged into six parts: setting the scene; financial reporting by listed groups using IFRS or US GAAP; China and Japan; financial reporting by individual companies; major issues for MNEs; and monitoring and enforcement.

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Useful websites

Accounting Education	www.accountingeducation.com
European Accounting Association	www.eaa-online.org
International Accounting Standards Board	www.ifrs.org
International Federation of Accountants	www.ifac.org
United Nations Conference on Trade and Development	www.unctad.org
World Bank	www.worldbank.org
World Federation of Exchanges	www.world-exchanges.org
World Trade Organization	www.wto.org

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

1.1* How has financial reporting been affected by major political and economic events in the world since the end of the Second World War?

1.2* Why have the major accounting firms become 'international'? From what countries have they mainly originated? Why?

1.3 What major contributions to accounting and its terminology have, historically, been made by the following countries: Italy, the United Kingdom, the United States, Japan?

1.4 Which are the top three countries in respect of:

(a) share of the world's top 500 companies;
(b) number of qualified accountants;
(c) market capitalization of stock exchange?

Why is the answer not the same for all three questions?

1.5 What factors have made possible the 'internationalization' of the world's stock markets?

1.6 What factors have led to the establishment of multinational enterprises?

1.7 Which countries, historically, have been the home countries of MNEs? Are they the same countries from which international accounting firms have originated?

1.8 Why are there more accountants per head of population in New Zealand than in France?

1.9 Why are some EU companies listed on non-European (especially North American) stock exchanges?

1.10 Why is English the leading language of international corporate financial reporting?

2 Causes and examples of international differences

CONTENTS

2.1 Introduction
2.2 Culture
2.3 Legal systems
2.4 Providers of finance
2.5 Taxation
2.6 Other external influences
2.7 The profession
2.8 Conclusion on the causes of international differences
2.9 Some examples of differences
  2.9.1 Conservatism and accruals
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  2.9.3 Measurement of tangible assets
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OBJECTIVES

After reading this chapter, you should be able to:

- discuss the degree to which international cultural differences might explain accounting differences;
- outline the two main types of legal system to be found in the Western world and how these are related to accounting differences;
- explain how the predominant methods of financing of companies can differ internationally and how this may affect the purpose and nature of accounting;
- illustrate the linkages between taxation and financial reporting, and show how these are stronger in some countries than in others;
- outline the relationships between international accounting variations and differences in the accountancy profession;
- synthesize all the above relationships to begin to explain international differences in financial reporting;
- outline various ways in which accounting under German national rules is more conservative than that under UK rules;
- explain the difference between a provision and a reserve, and show how the definition of provision is wider in some countries than in others;
- outline the main valuation bases used for assets in major countries; and
- summarize the international differences in formats of financial statements.

2.1 Introduction

The existence of major international differences in accounting practices is not obvious to all accountants, let alone to non-accountants. The latter may see accounting as synonymous with double-entry bookkeeping, which is indeed similar universally. Much of this book investigates the major differences in accounting. Some examples are given in Section 2.9. As a prelude to this, we try to identify the likely causes of the differences. It is not possible to be *sure* that the factors discussed below cause them, but a relationship can be established and reasonable deductions made.

A large list of possible causes of international differences can be found in the writings of previous researchers (e.g. Choi and Meek, 2008, Chapter 2; Radebaugh, Gray and Black, 2006, Chapter 3). Some researchers have used their estimates of such causes as a means of classifying countries by their accounting systems (see Chapter 3). Other researchers have studied whether perceived differences in accounting practices correlate with perceived causal factors (e.g. Frank, 1979; Doupnik and Salter, 1995).

Jaafar and McLeay (2007) examine whether accounting differences between companies are mainly influenced by a company's country, size, sector or number of stock exchange listings. They find that all these factors have some effect, but that country is far more important than all the other factors. Jaafar and McLeay's research is set in the context of national accounting systems, before the widespread use of IFRS. The same applies to most of this chapter. However, we will see later (e.g. Chapters 3 and 7) that the national influences still affect practices under IFRS.

Before going further, it is also important to define 'accounting'. In this context, we mean published annual financial reporting by companies. By 'accounting system', we mean the set of financial reporting practices used by a particular population of companies for their annual reports. Different companies in a country may use different accounting systems. Further, any one company may use different accounting systems for different purposes. For example, in many EU countries, consolidated statements are prepared using IFRS whereas unconsolidated statements use national rules. This chapter investigates why and how national systems differ. The ideas here can also be used to explain why different countries might exhibit different styles of IFRS practice, as explained further in Chapter 7.

Several factors that seem linked to the differences in accounting systems are now examined. These are not necessarily causes of the differences; they might be results, as will be discussed later.

2.2 Culture

Clearly, accounting is affected by its environment, including the culture of the country in which it operates. Hofstede (1980) develops a model of culture as the collective programming of the mind that distinguishes the members of one human group from another. Hofstede argues that, much as a computer operating system contains a set of

rules that acts as a reference point and a set of constraints to higher-level programs, so culture includes a set of societal values that drives institutional form and practice. As Gray (1988, page 5) notes:

> societal values are determined by ecological influences and modified by external factors . . . In turn, societal values have institutional consequences in the form of the legal system, political system, nature of capital markets, patterns of corporate ownership and so on.

Culture in any country contains the most basic values that an individual may hold. It affects the way that individuals would like their society to be structured and how they interact with its substructure. Accounting may be seen as one of those substructures. As Gray (1988, page 5) explains:

> the value systems or attitudes of accountants may be expected to be related to and derived from societal values with special reference to work related values. Accounting 'values' will in turn impact on accounting systems.

To get some idea of the basic cultural patterns of various countries, we turn again to Hofstede. Based on a study of over 100,000 IBM employees in 39 countries, Hofstede (1984, pages 83, 84) defined and scored the following four basic dimensions of culture, which can be summarized as follows:

1. *Individualism versus collectivism.* Individualism means a preference for a loosely knit social framework in society wherein individuals are supposed to take care of themselves and their immediate families only. The fundamental issue addressed by this dimension is the degree of interdependence that a society maintains among individuals.
2. *Large versus small power distance.* Power distance is the extent to which the members of a society accept that power in institutions and organizations is distributed unequally. People in societies that have large power distance accept a hierarchical order in which everybody has a place which needs no further justification. The fundamental issue addressed by this dimension is how society handles inequalities among people when they occur.
3. *Strong versus weak uncertainty avoidance.* Uncertainty avoidance is the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity. This feeling leads them to beliefs promising certainty and to maintain institutions protecting conformity. Societies with strong uncertainty avoidance maintain rigid codes of belief and behavior and are intolerant towards deviant persons and ideas. Weak uncertainty avoidance societies have a more relaxed atmosphere in which practice counts more than principles and deviance is more easily tolerated. A fundamental issue addressed by this dimension is how a society reacts to the fact that time runs only one way and that the future is unknown: whether it tries to control the future or lets it happen.
4. *Masculinity versus femininity.* Masculinity stands for a preference in society for achievement, heroism, assertiveness and material success. Its opposite, femininity, stands for a preference for relationships, modesty, caring for the weak and the quality of life.

Gray (1988) applies these cultural differences to explain international differences in the behavior of accountants and therefore in the nature of accounting practices. For example, Gray suggests that a country with high uncertainty avoidance and low individualism will be more likely to exhibit conservative measurement of income and a preference to limit disclosure to those closely involved in the business. Conservatism is examined as an example of international differences later in this chapter.

Gray developed the following pairs of contrasting 'accounting values':

- professionalism versus statutory control;
- uniformity versus flexibility;
- conservatism versus optimism;
- secrecy versus transparency.

The first two pairs relate to authority and enforcement. Here Gray sees a clear contrast between the 'Anglo' culture area on the one hand and Asian areas on the other. The second two pairs relate to measurement and disclosure. Gray contrasts the 'Anglo' and the Latin and Germanic cultures.

This approach may well be particularly useful for examining such issues as international differences in the behaviour of auditors (e.g. Soeters and Schreuder, 1988) or the choice of auditors (Hope *et al.*, 2008). However, for financial reporting, the measures of cultural attributes seem vague and indirect, compared with the measurement of directly relevant elements of the external environment of accounting, such as legal systems or equity markets (see below). Also, the cultural data may not be reliable in an accounting context. For example, Hofstede classifies West African countries together, but they have very different legal and accounting systems. Another problem arises from the fact that, for good reasons, Hofstede looked at employees in a large multinational company. When measuring cultural attributes, how does one cope with the fact that many employees of multinationals in Abu Dhabi, Singapore, etc. come from other countries or from particular minority populations? McSweeney (2002) makes a series of criticisms of Hofstede's methodology. Baskerville (2003) also suggests that it is dangerous to equate nation with culture and that there are difficulties in trying to understand a culture by means of numerical indices. However, Hofstede (2003) counters the criticisms.

Salter and Niswander (1995) tried to test Gray's hypothesis for 29 countries but met considerable difficulty in measuring several of Gray's 'accounting values', so that indirect measures were generally used. For example, the degree of uniformity was partly measured by whether a country has common law or code law, but this is not really a test of differences in accounting practices but a test of a possible cause of them. For a more direct measure of uniformity, Gray's hypothesis did not hold. For conservatism, some hypothesized relationships held and others did not. The most convincing support for an element of Gray's hypothesis was that transparency increased as uncertainty avoidance decreased, but the other predictions related to secrecy did not hold. Chanchani and Willett (2004) sampled the accounting values of preparers and users of financial statements in India and New Zealand. They found some support for Gray's constructs of professionalism and uniformity.

Chanchani and MacGregor (1999) provide a summary of papers on accounting and culture. Doupnik and Tsakumis (2004) update this. Doupnik (2008) examines

the influence of culture on earnings management, such as the smoothing of earnings over time, and finds that high uncertainty avoidance and low individualism are associated with the smoothing of earnings. Ronen and Shenkar (2013) produce a picture of the world in clusters based on work-related attitudes. The picture shows clear 'Arab' and 'Anglo' clusters, but less cohesive clusters in East Asia or among 'Latin' countries. Chand *et al*. (2012) show how different cultures in the same country can affect accounting judgements; they study Australian students with Chinese backgrounds and those with Anglo-Celtic backgrounds.

Heidhues and Patel (2011) suggest that many researchers have applied Gray's model uncritically. Heidhues and Patel take Germany as a case study, and examine the possible drivers of secrecy and conservatism. Although this detailed approach is necessary for a proper understanding of accounting in any country, the findings of Heidhues and Patel do not seem directly to contradict anything in the Gray model.

We certainly conclude that another way of looking at the environment of accounting is to identify more direct potential influences such as legal systems, corporate financing, tax systems and so on. These interact with culture in a complex way, and they seem to affect the style of financial reporting and accountancy profession that a country has. We look at some of these external environmental factors in the rest of this chapter.

When studying possible causes of accounting differences, it will also be useful to note that the environment of accounting may include the effects of imperialism. Many countries are heavily influenced by others, particularly former colonial powers whose culture may be overwhelming. Consequently, when predicting or explaining the accounting requirements of many African or Asian countries, it may be more efficient to look at the colonial history rather than at other possible causes. These issues are taken up again when classification is discussed in Chapter 3, and they are referred to in some later chapters for particular countries.

2.3 Legal systems

Some countries have a legal system that relies upon a limited amount of statute law, which is then interpreted by courts, which build up large amounts of case law to supplement the statutes. Such a 'common law' system was formed in England, primarily after the Norman Conquest, by judges acting on the king's behalf (van Caenegem, 1988). It is less abstract than codified law (see below); a common law rule seeks to provide an answer to a specific case rather than to formulate a general rule for the future. Although this common law system emanates from England, it may be found in similar forms in many countries influenced by England. Thus, the federal law of the United States, the laws of Ireland, India, Australia and so on, are to a greater or lesser extent modelled on English common law. This naturally influences commercial law, which traditionally does not prescribe detailed rules to cover how companies should prepare their financial statements. Instead, accountants themselves established rules for accounting practice, which were then written down as recommendations

or standards. Later, standard-setting bodies independent of both the state and the accountancy profession have been set up. In many such jurisdictions, the legal system is now involved in the enforcement of the standards.

Other countries have a system of law that is based on the Roman *ius civile* as compiled by Justinian in the sixth century and developed by European universities from the twelfth century. Here, rules are linked to ideas of justice and morality; they become doctrine. The word 'codified' may be associated with such a system. This difference has the important effect that company law or commercial codes establish rules for accounting and financial reporting. For example, in Germany, company accounting under domestic rules is to a large extent a branch of law.

Table 2.1 illustrates the way in which some developed countries' legal systems fall into these two categories. The modern commercial legal systems of both China and Japan were based on translations of the German commercial code of the late nineteenth century (see Chapter 11). In some Roman law countries, *dirigisme* (centralization and a desire to control the economy) results in the existence of an 'accounting plan' (see Chapter 14). Classification of legal systems is discussed by David and Brierley (1985).

It is clear that the nature of accounting regulation in a country (as opposed to the content of the accounting rules) is affected by its general system of laws. This is the subject of Chapters 14 and 20. There also seems to be some association of common law countries and large equity markets (see Section 2.4). Further, there is an association of common law countries with particular types of accounting practices, but causation is unclear (see Section 2.8). Jaggi and Low (2000) find, for example, that companies in common law countries have higher levels of disclosures. Bushman and Piotroski (2006) examine the greater incentives to report losses quickly in common law countries.

Lindahl and Schadéwitz (2013) cast doubt on the usefulness of the common/code distinction for understanding accounting differences. They suggest that there are important differences within the two legal families. Also, harmonization (e.g. in the EU) has narrowed the differences between some common law countries and some code law countries.

Even if a country's regulatory system for accounting is affected by the nature of its legal system, the accounting rules and practices might be more affected by other issues. At the extreme, a country might adopt IFRS for some or all purposes, irrespective of its legal system.

Table 2.1 Western legal systems

Common law	Codified Roman law
England and Wales	France
Ireland	Italy
United States	Germany
Canada	Spain
Australia	Netherlands
New Zealand	Portugal
	Japan (commercial)

Note: The laws of Scotland, Israel, South Africa, Quebec, Louisiana and the Philippines embody elements of both systems.

2.4 Providers of finance

The prevalent types of business organization and ownership also differ. In Germany, France and Italy, capital provided by banks is very significant, as are small family-owned businesses. By contrast, in the United States and the United Kingdom there are large numbers of companies that rely on millions of private shareholders for finance. Evidence that this characterization is reasonable may be found by looking at the number of listed companies in various countries. Table 1.5 in the previous chapter shows the numbers of domestic listed companies on Stock Exchanges in some large economies. Table 2.2 takes similar data for four countries and puts them into context by deflating them for the size of the population or economy. It shows how much more important the equity market is in the United States or United Kingdom than it is in Germany or Italy.

The comparison between the United States or United Kingdom and Germany or Italy is instructive. A two-group categorization of these countries is almost as obvious as that for legal systems in Table 2.1. La Porta *et al*. (1997) find a statistical connection between common law countries and strong equity markets. La Porta *et al*. (1998) note that common law countries have stronger legal protection of investors than Roman law countries do. Lindahl and Schadéwitz (2013) cast doubt on the scores for legal protection in these papers. Roe (2003) argues that the differences between corporate structures in the developed West are caused by political differences. These political differences not only directly affect corporate structures, they also influence the technical institutions (e.g. legal arrangements) that affect corporate structures.

Incidentally, the country with the longest history of 'public' companies is the Netherlands. Although it has a fairly small stock exchange, many multinationals (such as Unilever, Philips, Royal Dutch) are listed on it. It seems reasonable, then, to place the Netherlands with the English-speaking world in an 'outside shareholder' group as opposed to a 'bank/family' group. Also, Table 2.3 shows average gearing ratios of companies in various countries. On the whole these fit the hypothesis, because less reliance on equity suggests more reliance on debt. The United States has low gearing, as has also the United Kingdom.

Table 2.2 The strength of equity markets, 2012

	Domestic listed companies/ million of population	Equity market capitalization/GDP
Italy	4.5	0.22
Germany	8.2	0.40
United States	12.9	1.11
United Kingdom	64.4	1.13

Source: Prepared by the authors from World Bank statistics (such as, http://data.worldbank.org/indicator/CM.MKT.LDOM.NO, accessed 125 April 2015).

Table 2.3 Gearing ratios of selected countries

Rank	Country	Gearing*
1	Spain	240.26
2	Germany	236.35
3	Ireland	223.20
4	Greece	194.15
5	Denmark	186.32
6	Italy	177.99
7	Japan	175.33
8	Australia	146.82
9	Belgium	129.95
10	Sweden	129.15
11	Austria	121.61
12	France	120.64
13	Norway	112.15
14	Poland	108.72
15	UK	107.07
16	Switzerland	100.55
17	US	98.03
18	Canada	87.10
19	New Zealand	72.68

Note: *Debt as percentage of common equity.
Source: Data from Datastream. Kindly provided in 2007 by Jon Tucker and David Bence of Bristol Business School.

A proposed grouping of countries into types by financial system has been formalized by Zysman (1983) as follows:

- capital market systems (e.g. United Kingdom, United States);
- credit-based governmental systems (e.g. France, Japan);
- credit-based financial institution systems (e.g. Germany).

Parker (1994) applies this analysis to 10 countries of the western Pacific and suggests its explanatory power for financial reporting practices.

Zysman's three types could be simplified further to 'equity' and 'credit'. A further point of comparison is that, in 'credit' countries, even the relatively few listed companies may be dominated by shareholders who are bankers, governments or founding families. For example, in Germany, the banks are important owners of companies as well as providers of debt finance. A majority of shares in many public companies are owned or controlled as proxies by banks, for example, by the Deutsche Bank. In such countries as Germany, France or Italy, the banks or the state will, in many cases, nominate directors and thus be able to obtain information and affect decisions. Table 2.4 shows the types of shareholders in listed companies in three European countries in 1977, before EU harmonization or international standards had affected those countries. As may be seen, the 'insider' proportion of shareholdings (T1) is larger than the outsider proportion (T2) in France and Germany, but the position startlingly the reverse in the UK.

As Table 2.5 shows, the difference between the countries has gradually reduced over time, but was still very clear in 2012. The most dramatic change in the type of

Table 2.4 **Percentages of insider and outsider shareholders, 1977**

	Banks	Other companies	Government	T1	Financial institutions	Domestic individuals	Foreign	T2
France	12	36	12	60	10	20	10	40
Germany	10	42	9	61	7	23	14	44
UK	1	4	3	8	51	37	5	93

Source: Prepared from OEE/IODS, 2012. The data for Germany and the UK do not add up to 100%. This is probably due to rounding for the UK.

Table 2.5 **Percentages of holdings of outsider shareholders**

	1977	1987	1997	2007	2012
France	40	50	68	67	69
Germany	44	46	46	62	55
UK	93	91	99	97	94

Source: Prepared from tables in OEE/IODS, 2012.

Table 2.6 **Percentages of holdings of foreign shareholders**

	1977	1987	1997	2007	2012
France	10	11	32	39	42
Germany	14	17	15	41	28
UK	5	10	24	44	48

Source: Prepared from tables in OEE/IODS, 2012.

shareholders, for all the three countries, relates to foreign investors. Table 2.6 shows a huge increase in such investors in all the countries. This must be expected to push the harmonization of accounting. However, it might be evidence of the reverse process. That is, by 2007, listed companies in all three countries were using international standards, so investors probably feel more comfortable with the financial reporting produced by foreign companies.

If even listed companies in continental European countries are dominated by banks, governments or families, the need for published information is less clear. This also applies to audit, because this is designed to check up on the managers in cases where the owners are 'outsiders'. Franks and Mayer (2001) discuss the ownership and control of German companies.

Although shares in countries such as the United Kingdom and the United States are increasingly held by institutional investors rather than by individual shareholders (see Chapter 1), this still contrasts with state, bank or family holdings. The following hypothesis is suggested: in countries with a widespread ownership of companies by shareholders who do not have access to internal information, there will be a pressure

for disclosure, audit and 'fair' information. Institutional investors hold larger blocks of shares and may be better organized than private shareholders. So, they should increase this pressure, although they may also be able successfully to press for more detailed information than is generally available to the public.

'Fair' needs to be defined. It is a concept related to that large number of outside owners who require unbiased information about the success of a business and its state of affairs (Flint, 1982; Parker and Nobes, 1994). Although reasonable prudence will be expected, these shareholders are interested in comparing one year with another and one company with another; thus some degree of realism will be required. This entails judgement, which entails experts. This expertise is also required for the checking of the financial statements by auditors. In countries such as the United Kingdom, the United States and the Netherlands, this can, over many decades, result in a tendency for accountants to work out their own technical rules. This is acceptable to governments because of the influence and expertise of accountants, which is usually running ahead of the interest of the government (in its capacity as shareholder, protector of the public interest or collector of taxation). Thus 'generally accepted accounting principles' control accounting and these are set by committees dominated by accountants and in the private sector. To the extent that governments intervene, they impose disclosure, filing and enforcement requirements.

In most continental European countries and in Japan, the comparative lack of 'outsider' shareholders meant that external financial reporting was largely invented for the purposes of protecting creditors and for governments, as tax collectors or controllers of the economy. This did not encourage the development of flexibility, judgement, fairness or experimentation. However, it did lead to precision, uniformity and stability. It also seems likely that the greater importance of creditors in these countries led to more careful (prudent, conservative) accounting. This is because creditors are interested in whether, in the worst case, they are likely to get their money back, whereas shareholders may be interested in an unbiased estimate of future prospects.

Nevertheless, even in such countries as Germany, France or Italy, where there are comparatively few listed companies, governments have recognized the responsibility to require public or listed companies to publish detailed, audited financial statements. There are laws to this effect in such countries, and governments have also set up bodies specifically to control the securities markets: in France in the 1960s, the Commission des Opérations de Bourse and its successor the Autorité des Marchés Financiers; and in Italy in the 1970s, the Commissione Nazionale per le Società e la Borsa (CONSOB). More recently, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) was set up in Germany. These bodies are to some extent modelled on the Securities and Exchange Commission (SEC) of the United States (see Chapter 8). They have been associated with important developments in financial reporting, generally in the direction of Anglo-American practice. This is not surprising, as these stock exchange bodies are taking the part otherwise played by private and institutional shareholders who have, over a much longer period, helped to shape Anglo-American accounting systems.

To some extent, this clear picture has been changing. For example, institutional and private investors have been increasing in importance in France and Germany (see Table 2.5). Also, as explained in Chapter 14, private sector standard-setters were set up in those two countries in the late 1990s. Nevertheless, the two-way contrast seems intact.

Table 2.7 Initial classification based on corporate financing

A	B
Features	
Strong equity market	Weaker equity market
Many outside shareholders	Core, insider shareholders
Large auditing profession	Small auditing profession
Separate accounting and tax rules	Tax dominates accounting rules
Examples of countries	
Australia	France
United Kingdom	Germany
United States	Italy

In conclusion, we suggest that this differentiation between credit/insiders and equity/outsiders is the key cause of international differences in financial reporting. An initial classification of some countries on this basis is suggested in Table 2.7.

Several important results flow from this two-way split. First, in credit/insider countries (Type B in Table 2.7), there was no great market demand for audited and published financial reporting. The demand for annual accounting is therefore strongly associated with the government's need for a calculation of taxable income. Consequently, tax considerations will dominate accounting rules. By contrast, in equity/outsider countries, accounting performs a market function, and so the rules need to be separated from taxation. The result is two sets of accounting rules: one for financial reporting and one for the calculation of taxable income. This is examined in the next section.

If a significant equity market does develop, one approach to satisfying its demand for a different type of information is to impose a different set of rules (e.g. IFRS) for the consolidated statements of listed companies. This can be done without affecting domestic accounting rules or the calculation of taxable income or distributable income.

A second effect of the split of countries based on financing systems is that credit/insider countries will need far fewer auditors than equity/outsider countries. This will affect the age, size and status of the accountancy profession, as examined in Section 2.7.

2.5 Taxation

Although it is possible to make groupings of tax systems in a number of ways, only some of them are of relevance to financial reporting. For example, it is easy to divide countries into those using 'classical' and those using 'imputation' systems of corporation tax (see James and Nobes, 2015). However, this distinction (which particularly affects how dividends are taxed) does not have a major effect on financial reporting.

What is much more relevant is the degree to which taxation regulations determine accounting measurements, for reasons discussed in the previous section. To some extent this is seen by studying deferred taxation, which is caused by differences between tax and accounting treatments. In the United Kingdom and the United States, for example, the problem of deferred tax has caused much controversy and a considerable amount of accounting standard documentation. However, under German national accounting rules, the problem was minor until recently because the tax rules *are* largely the accounting rules. In Germany, the tax accounts (*Steuerbilanz*) were, until recently, the same as the commercial accounts (*Handelsbilanz*). There is even a word for this idea: the *Massgeblichkeitsprinzip* (Haller, 1992).

One obvious example of the areas affected by this difference is depreciation. In the United Kingdom the amount of depreciation charged in the published financial statements is determined according to custom established over the last century. This was eventually written down in the accounting standards SSAP 12, then FRS 15 and now FRS 102, which requires an entity to:

> allocate the depreciable amount of an asset on a systematic basis over its useful life (para. 17.8)

The requirements of the standard are fairly general (rather like those in the similar International Financial Reporting Standard, IAS 16). Convention and pragmatism, rather than exact rules or even the spirit of the standard, determine the method chosen (usually straight-line, because it is easier), the size of the residual value (usually zero, because it is easier) and the expected length of life (often 10 years for machines, because it is easier).

The amount of depreciation allowed for *tax* purposes in the United Kingdom is quite independent of these accounting figures. It is determined by capital allowances, which are a formalized scheme of tax depreciation allowances designed to standardize the amounts allowed and to act as investment incentives. For example, in 2015/16, for UK tax purposes, machinery is depreciated at 20 per cent per year on a reducing balance basis. Unlike other countries, the United Kingdom does not give any depreciation tax allowance for most buildings. Because of the separation of the two schemes of depreciation, there can be a complete lack of subjectivity in tax allowances, but full room for judgement in financial depreciation charges.

At the opposite extreme, in countries such as Germany, the tax regulations lay down maximum depreciation rates to be used for particular assets. These are generally based on the expected useful lives of assets. However, in some cases, accelerated depreciation allowances are available: for example, this has been the case for industries producing energy-saving or anti-pollution products or for those operating in parts of eastern Germany. If these allowances are to be claimed for tax purposes (which would normally be sensible), they must be charged in the financial statements. Thus, the charge against profit would be considered by a UK accountant to be not 'fair', even though it could certainly be 'correct' or 'legal'. This influence has been felt even in the details of the choice of method of depreciation in Germany, as shown by an explanation from BASF, the German chemical company: 'Movable fixed assets are mostly depreciated by the declining-balance method, with a change to straight-line depreciation when this results in higher depreciation amounts' (2010 Annual Report of parent company, page 30). BASF also reported (page 31) that: 'To the extent

that the recognition of special reserves on the balance sheet is required for fiscal acceptance, the amount is set in accordance with fiscal regulations'. However, the close connection between tax and accounting has been somewhat lessened recently (see Chapter 14). In the BASF 2014 report, the 'fiscal acceptance' sentence has been deleted, and the depreciation method has changed to straight-line, although older assets are still depreciated using reducing balance until straight-line leads to a larger expense (page 38).

A depreciation example from France is provided by the parent company financial statements of L'Oréal in 2014 which refer to 'accelerated tax-driven' amortization of intangible assets and depreciation of tangible assets (page 185). Further examples of tax influence were easy to find: bad debt allowances (determined by tax laws in Italy or Spain) or government-induced revaluations of assets (e.g. in France in 1978, Spain in 1986 and Italy in 2000).

With some variations, this *Massgeblichkeitsprinzip* operates in Germany, France, Belgium, Japan and many other countries. It is perhaps due partly to the pervasive influence of codification in law, and partly to the predominance of tax authorities as users of accounting. A major exception to this point, concerning consolidated statements, became particularly important in the 1990s. As taxation generally relates to the taxable income of individual companies rather than that of groups, the authorities are able to take a relaxed view about consolidated statements. This has facilitated international harmonization of accounting at the group level. For example, since 2005, consolidated statements of listed companies in the EU use IFRS. Similarly, in China and Japan, different accounting rules apply to consolidated statements.

The alternative approach, exemplified by the United Kingdom, the United States, Australia and the Netherlands, is that published financial statements are designed mainly as performance indicators for investment decisions, and so commercial rules operate separately from tax rules in a number of accounting areas. The countries on the left in Table 2.1 are, in varying degrees, like this. In most cases, there is not the degree of separation between tax and financial reporting that is found in the United Kingdom in the shape of capital allowances. However, in all such countries the taxation authorities have to make many adjustments to the commercial accounts for their own purposes. There is a major exception to this in the use of last-in-first-out (LIFO) inventory valuation in the United States, largely for tax reasons (see Chapter 8).

Attempts have been made to put countries into groups by the degree of connection between tax and financial reporting. For example, Hoogendoorn (1996) classifies 13 countries. However, there are problems with this because seven groups are necessary for the classification, and two matters are being considered at the same time: the tax/reporting connection, and the treatment of deferred tax. Lamb et al. (1998) try to separate out the first issue. They conclude that it is possible to distinguish between UK/US separation of tax and accounting and a German close connection. Their methodology was later applied in analyses involving Spain (Oliveras and Puig, 2005), Norway (Nobes and Schwencke, 2006) and Italy (Gavana *et al.,* 2013). Nobes and Schwencke (2006) studied the development of tax and reporting links over time. They took Norway as a case study, and charted its move from close connection to separation over a century.

In Germany, some differences between tax and financial reporting have arisen since the study of Lamb et al. (1998). For example, for tax purposes, impairments are only allowed if they are expected to be long lasting. Also, long-term provisions should be discounted. Chapter 15 notes several further changes to German accounting from 2010 that reduce the closeness of tax and financial reporting.

These above measures of tax connections relate to national accounting and tax rules, and therefore to unconsolidated statements. For consolidated statements, it is much easier for reporting to escape tax influence. Lamb et al. (1998) note this for France. The use of IFRS for consolidated reporting should greatly reduce or even eliminate the effects of taxation. However, tax influence is still possible where accounting choices in unconsolidated accounting are made for tax reasons and those choices flow through to consolidated statements. Gee *et al.* (2010) use the Lamb *et al.* methodology to examine Germany and the UK in the context of IFRS consolidated statements. Gavana *et al.* (2013) also examine IFRS in Italy. These various authors show that that tax influence has been greatly reduced, but not eliminated, in German and Italian IFRS statements. All the studies involve a great deal of judgement about the relationship between tax and FR rules. Those based on Lamb *et al.* are also very laborious, which is why they deal with a small number of countries.

All the above are qualitative approaches to assessing tax influence, although most result in numerical scores. Recently, there have been some attempts at a quantitative approach using company data for several countries. Atwood *et al.* (2010) measure book-tax conformity (BTC) based on the amount of observed variation in current tax expense (used as a proxy for taxable income) that cannot be explained by the variation in profit before tax (*PBT*). They apply their model to 33 countries for the period 1992–2005. They show, for each country, the average for the whole period of the standard error (SE) from annual regressions of current tax expense on *PBT*. High SE indicates low BTC. Tang (2015) has a somewhat different ambition for measuring BTC, as she aims to capture what she calls the 'mandatory conformity'. Tang finds it by year and by country (32 countries over 1994–2007) as the SE of a regression of book-tax difference (measured as *PBT* multiplied by the statutory tax rate, minus the current tax expense) on discretionary accruals (modified Jones-style) and a proxy for tax avoidance.

The data used by Atwood *et al.* (2010) and Tang (2015) are largely overlapping. To some extent, they come to similar conclusions, e.g. the USA and Canada have low BTC. However, their rankings of some Asian countries (e.g. Hong Kong and Singapore) are very different: low BTC according to Atwood *et al.* (2010) and high BTC according to Tang (2015).

In many countries, IFRS (or IFRS for SMEs) has been adopted (or converged with) even for the purposes of unconsolidated financial reporting (see Chapter 12). This implies the necessity for extensive disconnection of tax from financial reporting. Otherwise, every time the IASB changes a standard, taxable income might change. Disconnection is especially important in countries (e.g. Denmark, the Netherlands, Norway and the UK) where companies have a choice of using IFRS or national rules, leading to two different profit figures. Without disconnection, companies could choose their taxable income by choosing whether to use IFRS or domestic accounting rules. Differences between a company's tax base and its financial reporting lead to the accounting topic of deferred tax. This is dealt with in Chapter 9.

2.6 Other external influences

Cultural influences on accounting development have already been discussed. Also, it has been suggested that colonial influence may overwhelm everything else. Many other influences have also been at work in shaping accounting practices, such as the framing of a law in response to economic or political events. For example, the economic crisis in the United States in the late 1920s and early 1930s produced the Securities Exchange Acts that diverted US accounting from its previous course by introducing extensive disclosure requirements and state control (usually by threat only) of accounting standards. Other changes to US accounting happened in response to the collapse of Enron in 2001 and the global financial crisis of 2007 onwards.

Other examples of outside influences include the introduction into Italy of Anglo-American accounting principles by choice of the government, and the introduction into Luxembourg of consolidation and detailed disclosure as a result of EU Directives – both against all previous trends there. In Spain, the adoption of the accounting plan from France followed French adoption of it after influence by the occupying Germans in the early 1940s. Perhaps most obvious and least natural is the adaptation of various British Companies Acts or of international standards by developing countries with a negligible number of the sort of public companies or private shareholders that have given rise to the financial reporting practices contained in these laws or standards. In its turn, in 1981 the United Kingdom adopted uniform formats derived from the 1965 *Aktiengesetz* of Germany because of EU requirements. For their part, Roman law countries now have to grapple with the 'true and fair view' (see Chapter 13).

A major example of external influence is the adoption of, or convergence with, the standards of IASB. For example, the EU has made these standards compulsory for the consolidated statements of listed companies. This was done for political and economic reasons (see Chapter 5) and it overrides the other factors in this chapter. More subtly, the remaining national standards of the EU and elsewhere are gradually converging with the international standards.

Another factor which has affected accounting practices is the level of inflation. Although accountants in the English-speaking world have proved remarkably immune to inflation when it comes to decisive action, there are some countries where inflation has been overwhelming. In several South American countries, the most obvious feature of accounting practices was the use of methods of general price-level adjustment (Tweedie and Whittington, 1984). The choice of this comparatively simple method was probably due to the correlation of inflation with any particular specific price changes when the former is in hundreds of per cent per year; to the objective nature of government-published indices; to the connection of accounting and tax; and to the paucity of well-trained accountants. Without reference to inflation, it would not be possible to explain accounting differences in several countries severely affected by it.

In continental Europe, the fact that it was governments that responded to inflation in France, Spain and Italy in the 1970s is symptomatic of the regulation of accounting in these countries. By contrast, in the United States, the United

Kingdom and Australia, it was mainly committees of accountants that developed responses to inflation in the 1970s. One might conclude that, although any country will respond to massive inflation, the more interesting point is that the reaction of a country's accounting system to inflation is an illustration of the basic nature of the system.

In a few cases, theory has strongly influenced accounting practice, perhaps most obviously in the case of microeconomics in the Netherlands. Accounting theorists there (notably Theodore Limperg, Jr) had advanced the case that the users of financial statements would be given the fairest view of the performance and state of affairs of an individual company by allowing accountants to use judgement, in the context of that particular company, to select and present accounting figures. In particular, it was suggested that replacement cost information might give the best picture. The looseness of Dutch law and tax requirements, and the receptiveness of the profession to microeconomic ideas (partly due, no doubt, to their training by the academic theorists), have led to diversity of practice, the emphasis on 'fairness' through judgement, and the experimentation with replacement cost accounting (Zeff *et al.*, 1992, Chapter 5).

In other countries, theory is less noticeable. In most of continental Europe and Japan, accounting has been the servant of the state (e.g. for tax collection). In the Anglo-Saxon world, theory was traditionally of little importance in accounting practice, although the development of conceptual frameworks since the mid-1970s has changed this (see Chapters 6 and 8).

2.7 The profession

Other issues are closely related to financial reporting, and have been thought by some researchers to cause international differences. One of these is the accountancy profession. However, this may be a dependent variable, not an explanatory one.

The strength, size and competence of the accountancy profession in a country may follow to a large extent from the various factors outlined above and from the type of financial reporting they have helped to produce. For example, the lack of a substantial body of private shareholders and public companies in some countries means that the need for auditors is much smaller than it is in the United Kingdom or the United States. However, the nature of the profession also feeds back into the type of accounting that *is* practised and *could be* practised. For example, a 1975 Decree in Italy (not brought into effect until the 1980s), requiring listed companies to have extended audits similar to those operated in the United Kingdom and the United States, could only be put into operation initially because of the substantial presence of international accounting firms. This factor constitutes a considerable obstacle to any attempts at significant and deep harmonization of accounting between some countries. The need for extra auditors was a controversial issue in Germany's implementation of the EU's Fourth Directive (Chapter 13).

The scale of the difference is illustrated in Table 1.11 in Chapter 1, which lists some accountancy bodies whose members act as auditors of the financial statements

of companies. These remarkable figures need some interpretation. For example, a German accountant may only be a member of the *Institut* if in practice, whereas at least half of the British figure represents members in commerce, industry, government, education and so on.

2.8 Conclusion on the causes of international differences

International differences in financial reporting are many and various, as is examined in detail throughout this book. Cultural differences are clearly of relevance here, at least as influences on factors that influence financial reporting. Doupnik and Salter (1995) suggest a model in which accounting differences can be explained by Gray's four cultural variables (see Section 2.2) plus six others (including the factors of Sections 2.3–2.7 above). However, Nobes (1998) suggests that this is problematic because (a) the cultural variables might be better seen as influencing the second six independent variables rather than directly affecting accounting, and (b) several of the second six variables (e.g. the nature of the accountancy profession) seem to be largely dependent rather than independent.

Nobes (1998) proposes that, at least for the purposes of dividing developed countries into major groups (see Chapter 3), the most important direct cause of the financial reporting differences is a two-way split of countries into: (i) those with important equity markets and many outside shareholders; and (ii) those with a credit-based financing system and with relatively unimportant outside shareholders. The equity/outsider system leads to decision-useful accounting, to a separation between tax and accounting rules and to large auditing professions. This is also often associated with the common law system, although the Netherlands seems to be an exception: a country with Roman law but where many other features related to accounting are like those of the United States or the United Kingdom.

Ball *et al.* (2000) suggest connections between common law and certain aspects of accounting, such as the speed of reporting of losses. As noted earlier, La Porta *et al.* (1997 and 1998) examine some connections between common law and large equity markets, but doubt has been cast on the accuracy and relevance of the common/code dichotomy.

Factors that might be relevant as causes but have not been addressed above include language, history, geography, religion, education and many others. Some of these may be too vague to be useful; for example, the history of equity markets or the legal system that may be particularly relevant, rather than history in general.

However, when looking at countries that are strongly culturally influenced from elsewhere (e.g. many former colonies), the best predictor of the accounting system is that it will be like that of the former colonial power. This will usually overwhelm other factors, even the corporate financing system. For example, some former British colonies in Africa have an accounting system based on that of the United Kingdom, even though they have no equity market at all. Elad (2015) shows how accounting practices in Africa can be predicted according to whether a country had British or French colonial influence. In other cases (e.g. New Zealand), a former colony may

inherit a legal system, an equity market and an accountancy profession, as well as an accounting system. For many Commonwealth countries, the British influence over accounting has now been replaced by that of the IASB.

Xiao *et al*. (2004) apply the ideas of Nobes (1998) and Ball *et al.* (2000) to the development of accounting in China. They suggest that governmental influence can slow down the rate at which an accounting system will change in response to a growing equity market. Tarca *et al.* (2013) examine the change towards IFRS in Germany and confirm the suggested link with the growth of outsider equity. Zeghal and Mhedhbi (2006) also show that, among developing countries, international standards are most likely to be adopted where there are capital markets and Anglo-American culture. However, Tyrrall *et al.* (2007) suggest that, at least in emerging economies, there is so much pressure from outside to use IFRS that the proposal in Nobes (1998) no longer applies. The issue is, instead, how quickly and fully IFRS is applied.

The various factors that influence accounting can still do so even once IFRS has been adopted. That is, IFRS can be practised differently in different countries. This is examined in Chapters 5 and 7.

2.9 Some examples of differences

There are many publications and academic papers that record international differences in accounting practices. For example, Jaafar and McLeay (2007) (mentioned earlier) look at inventory valuation, depreciation methods and goodwill treatment. Many other such papers are mentioned in the context of classification (Chapter 3) and harmonization (Chapter 4).

This section now looks at four accounting issues where major international differences can be found: conservatism, provisions, measurement of assets, and formats of financial statements.

2.9.1 Conservatism and accruals

The word 'conservatism' in the accounting literature has two different meanings. In this book we use it to mean the tendency to understate profit and assets. This is associated with the state's desire to limit dividends in order to protect creditors, and with a company's desire to limit taxable income. Another, narrower, meaning (e.g. Basu, 1997; Ball *et al*., 2000; Ryan, 2006) is the speed with which losses are reported. This is discussed further in Chapter 5.

Perhaps because of the different mix of users in differing countries, conservatism (in the former sense) is of different strengths. For example, the importance of banks in Germany may be a reason for greater conservatism in reporting. It is widely held that bankers are more interested in 'rock-bottom' figures in order to satisfy themselves that long-term loans are safe.

EU laws refer to 'prudence' rather than 'conservatism'. In many cases, accounting standards are the compromise treaties that settle a battle between prudence and the accruals concept. For example, it is not fully conservative to require the capitalization of some development expenditure as in IAS 38, but it may be reasonably prudent

under certain conditions. A similar argument applies to the taking of profit on some unfinished long-term contracts as in IFRS 15. Many Anglo-Saxon countries use similar ideas. For example, although US accounting practice does not generally allow capitalization of development expenditure, it does require gains to be accounted for on certain unsold investments. Hung (2000) finds that the use of accruals in various contexts reduces the usefulness of accounting information in some countries but not in Anglo-Saxon countries.

Continental European conservatism is of a more stringent variety, as may be illustrated by a study of published financial statements. The 2014 parent company report of BASF, the chemical company headquartered in Germany, provides the following examples, starting with that mentioned in Section 2.5 above:

> For declining-balance depreciations, a systematic transition to straight-line depreciation takes place if this results in higher depreciation amounts.
>
> BASF SE does not make use of the optional right to capitalize internally generated intangible assets forming part of fixed assets.
>
> Additions that cost more than €150 but not more than €410 are depreciated immediately in the year of purchase.
>
> Financing costs [on the construction of assets], costs for social services, costs for voluntary social benefits and pension costs are not capitalized.
>
> The acquisition or production costs of raw materials as well as work in process, finished goods and merchandise are determined by the last-in-first-out (LIFO) method.
>
> Construction in progress relates to chemical plants under construction for BASF Group companies. Profits are recognized on the final invoicing of a project or the invoicing of a part of a project.
>
> Other provisions are recognized for the expected amounts of contingent liabilities and probable losses from pending transactions, as well as to cover omitted maintenance procedures as of the end of the year, which will be incurred within the first three months of the following year.
>
> Noncurrent foreign-currency receivables are valued at the rate prevailing on the acquisition date or at the rate on the balance sheet date if lower. Noncurrent foreign-currency liabilities are recorded at the rate prevailing on the acquisition date or at the rate on the balance sheet date if higher.

This greater conservatism in continental Europe is a long-run phenomenon. Davidson and Kohlmeier (1966) and Abel (1969) noted that profit figures would be consistently lower in France, Sweden, Germany and the Netherlands (when use of replacement cost was assumed) if similar companies' statements were merely adjusted for differences in inventory and depreciation practices from those used in the United States or the United Kingdom.

One way of being more precise in this area is to construct a 'conservatism index'. Gray (1980) suggested the following ratio:

$$1 - \left[\frac{R_A - R_D}{|R_A|}\right]$$

where R_A = *adjusted profit, and* R_D = disclosed profit. A company with a ratio above 1 would be using relatively optimistic accounting practices, whereas a company with a ratio of less than 1 would be relatively conservative.

Gray (1980) examined a number of companies from France, Germany and the United Kingdom in the early 1970s in order to produce an index of conservatism. He concluded that 'French and German companies are significantly more conservative or pessimistic than UK companies' (page 69). However, the figures disclosed by Daimler-Benz for 1992 to 1995 for adjustments from German to US principles show that, in times of deep recession, German figures can be less conservative (see Section 2.9.2, below). As noted earlier, Ball *et al*. (2000) found that continental European companies took longer to recognize losses. Hellman (2008) reviews the literature on conservatism. He argues that removing the consistent conservatism that was common in continental Europe might lead to more opportunities for temporary conservatism that can later be reversed, because IFRS requires more estimates.

Gray used estimated adjustments by analysts for his data. Another source of data is that published by those companies that reconciled to US rules (see Table 1.1). Several researchers have used such data to construct conservatism indices for countries; other researchers refer instead to 'comparability indices'. Table 2.8 shows some details of those studies. In summary, the findings are that aspects of UK and Australian accounting were less conservative than US practice, but that continental European companies were generally more conservative.

More recent data on prudence can be found by examining the reconciliations of companies from domestic rules to IFRS. Staying with the example of Germany, Volkswagen's reconciliation shows more than a doubling of equity when moving from German rules to IFRS (see Table 2.9).

One major caveat, that was not always discussed by researchers, is that the companies that published this data may have been atypical of their countries. For example, a German company might have used the choices available in German law in order to conform to US rules as much as possible, so that there would be fewer items to adjust for on reconciliation. This means that it would be following legal but atypical German

Table 2.8 Studies of reconciliations to US GAAP

	Authors	Sample size	Countries	Period covered
1	Weetman and Gray (1991)	57	UK, Sweden, Netherlands	1986–8
2	Cooke (1993)	5	Japan	1989–91
3	Hellman (1993)	13	Sweden	1981–90
4	Norton (1995)	13	Australia	1985–93
5	Zambon and Dick (1998)	40	France, Germany, Italy	1983–96
6	Zambon (1998)	68	UK	1994–6
7	Weetman, Jones, Adams and Gray (1998)	25	UK	1988 and 1994
8	Rueschhoff and Strupeck (1998)	58	13 developing countries	1994
9	Adams, Weetman, Jones and Gray (1999)	41	UK	1994
10	Street, Nichols and Gray (2000)	33	Countries using IAS	1997
11	Whittington (2000)	2	UK and France	1988–96
12	Lang, Raedy, Wilson (2006)	698	38 countries	1991–2002

Source: By kind permission of Felix Soria, adapted from an unpublished draft PhD thesis, University of Reading, 2001; updated by the authors.

Table 2.9 **Volkswagen 2001 (opening reconciliation)**

	€m
Equity (German law) 1.1.2000	9,811
Capitalization of development costs	3,982
Amended useful lives and depreciation methods of tangible and intangible assets	3,483
Capitalization of overheads in inventories	653
Differing treatment of leasing contracts as lessor	1,962
Differing valuation of financial instruments	897
Effect of deferred taxes	−1,345
Elimination of special items	262
Amended valuation of pension and similar obligations	−633
Amended accounting treatment of provisions	2,022
Classification of minority interests not as part of equity	−197
Other changes	21
Equity (IFRS) 1.1.2000	20,918

Source: Adapted from *Volkswagen AG Annual Report 2001*. Volkswagen AG, Wolfsburg, Germany.

practices for its domestic accounting. This is clearly the case for Daimler-Benz in 1993–1995 (e.g. page 65 of the 1995 Annual Report).

A further example of the protection of creditors is the use of statutory or legal reserves in several continental European countries and Japan. These are undistributable reserves that are set up out of declared profits. They are an extra protection for creditors above the normal rules on the maintenance of capital. In France, Germany and Belgium a company is required to appropriate 5 per cent tranches of its annual profit until the statutory reserve reaches 10 per cent of issued share capital (20 per cent in Italy and Spain; 25 per cent in Japan).

This international difference in conservatism has largely survived international harmonization of domestic rules (see Chapter 13). For example, neither EU nor international harmonization efforts have addressed legal reserves. Also, the EU Fourth Directive made prudence an overriding principle in the German-language version (and most others) but not in the English-language version (Evans and Nobes, 1996).

2.9.2 Provisions and reserves

The area of 'provisions' and 'reserves' is fraught with linguistic difficulties. For example, in American English the word 'reserve' means either 'provision' or 'impairment' in UK English (see Table 2.10). We will use UK English here, but this still leaves another difficulty in that the word 'provision' is used to mean two things: (i) a liability of uncertain timing or amount (e.g. 'provision for pensions') and (ii) an allowance against (or impairment of) the value of an asset (e.g. 'bad debt provision' or 'provision for depreciation'). To avoid confusion in this section, we will use 'provision' to mean the first of these, and 'impairment' to mean the second. This is IFRS usage.

Table 2.10 National words for the IFRS terms 'provision' and 'reserve'

	Provision	Reserve
UK English	*Provision*	*Reserve*
American English	*Reserve, Contingency*	*[Element of equity]*
French	*Provision*	*Réserve*
German	*Rückstellung*	*Rücklage*
Italian	*Fondo*	*Riserva*

Setting up a provision or making an impairment involves a charge against income, but there is an important distinction. Making an impairment is a matter of measurement relating to an asset which has already been recognized. By contrast, setting up a provision requires three stages of consideration: (i) is there a liability? (ii) should it be recognized? (iii) how should it be measured? More attention will be given to this topic in Chapter 9.

The distinction between provisions and reserves is important for financial reporting because provisions are liabilities recognized by charges against profit, whereas reserves are elements of equity caused by undistributed gains. The influences that lead to a proliferation of provisions appear to be conservatism and generous tax regulations. Both these factors have been discussed, and their effects on provisions mentioned. The result of such provision accounting may be that the accruals convention, the definition of 'liability' and 'fairness' are partially overridden; this in turn may result in income smoothing. Provisions for risks and contingencies which fluctuate in reverse relationship with profits are examples of income smoothing.

With reference to Germany, remarks concerning provisions have already been made above. In IFRS or US GAAP, provisions for general risks are not supposed to be set up, and therefore income should not be smoothed by changing their size from year to year. In 1998, the IASC (see Chapter 4) brought some clarity to this area by requiring (in IAS 37) that a provision should be recognized when, and only when, there is a liability to a third party at the balance sheet date. Such rules would clearly outlaw BASF's provision for next year's repair expenses (see quotation in Section 2.9.1).

On the other hand, tax influence can sometimes have the opposite effect. For example, in many countries, pension expenses are not tax deductible until paid. In the United States and the United Kingdom, pension expenses are still charged (and the related pension provisions recorded) because the accounting rules require it. The same applies in IFRS consolidated statements in France. However, under French GAAP, many companies do not account for pension obligations because they are not relevant for tax. For example, L'Oréal's parent financial statements of 2014 (page 186) explain that no provisions are recognized for unfunded obligations.

This brings us to another language issue. That is, a provision (or a reserve) should not be confused with a pile of money or investments, which should be termed a 'fund' if it has been irrevocably transferred from the company's control. For example,

when a company recognizes that it has a liability to pay future pensions to current and former employees, it should set up a provision. However, this merely admits the obligation. If the company wishes to go further and set aside money outside of the company in order to pay these obligations, then it needs to set up a fund. For example, in the United Kingdom and the United States, it is customary for companies to send money to a legally independent pension fund or life assurance company. The resulting fund reduces the size of the provision shown in the balance sheet. Note (see Table 2.10) that the Italian word for provision is *fondo*, and this is also the Italian word for fund, which can increase confusion here.

2.9.3 Measurement of tangible assets

There is great international variation in the degree to which departures from a cost basis are allowed or required. In a country with detailed legal rules and a coincidence of tax and commercial accounting, the predominant valuation system will involve as little judgement as possible. Flexibility and judgement would make it difficult for auditors to determine whether the law had been obeyed and might lead to arbitrary taxation demands. Thus, in a country such as Germany, the required method of valuation under domestic rules is a strict form of historical cost. This also fits with the German opposition to inflation (and to adjustments for it), resulting from the scarring experiences of hyper-inflation after each of the two world wars.

At the other extreme is the Netherlands. Until recently, some Dutch companies (e.g. Philips) published replacement cost financial statements for four decades. Although this remained minority practice, during inflationary periods many Dutch companies have partially or supplementarily used replacement costs. Dutch practice reflected the influence of microeconomic theory and a striving after fairness. The Dutch bank, ING, chooses to measure its land and buildings (both investment property and other) at fair value under IFRS (see page 121 of the 2014 annual report). This is not the choice of any German bank under IFRS.

Between these two extremes, UK 'rules' until the late 1990s allowed a chaotic state of affairs, where some companies revalued, some of the time, using a variety of methods. This was the position for much of the English-speaking world, except that the United States and Canada kept to historical cost (except for financial assets) in the main financial statements because of the influence of the SEC. Throughout the English-speaking world during the inflationary 1970s and 1980s there was experimentation with current cost accounting, normally via supplementary statements. Now IFRS and UK rules allow revaluation of tangible assets, as long as it is continuous and applies to all assets of the same sort. In practice, use of fair value is rare except for investment properties (see Chapter 7). In France, Spain and Italy, where there is much tax and other government influence, there have been legal revaluations from time to time under national accounting rules, as noted earlier.

Some countries, notably in South America, have adopted forms of general purchasing power (GPP) adjusted accounting. This has occurred in countries with very high inflation, government/tax controlled accounting, and a paucity of accountants. Thus GPP satisfies the requirements of simplicity and uniformity, as a single inflation index can be used by all companies. GPP accounting is of course basically historical cost accounting with 'last minute' annual indexations.

2.9.4 Formats of financial statements

Balance sheets (or statements of financial position) vary in two main ways under domestic rules (see Table 2.11). First, in some countries, assets are displayed in order of decreasing liquidity (cash first), whereas in other countries there is an increasing order of liquidity (intangible fixed assets come first). The key to predicting is that the decreasing order is used by countries influenced by the United States, and the increasing order is used by countries in the EU.

The other main variation in balance sheets is the shape of them. Some combine together all the debits and then all the credits. Such balance sheets are either two-sided (with assets on the left) or in 'report form' on a single page (with assets at the top) – see the example of report form in Table 2.12. Other companies arrange the items in order to calculate totals of net current assets and net assets; this may be called a financial position format. These three shapes (with assets in order of increasing liquidity) are all allowed in the EU. There is no US requirement on the shape of balance sheets.

Table 2.12 records that the present EU model can be traced back to an earlier German format. As may be seen, the first (1971) draft of the Directive followed the previous German format quite closely. The final (1978) version of the Directive was the one included into member state laws (e.g. the UK Companies Act). The UK format shown is an option in UK law, in the 1981 Act and still in the 2006 Act. Normally, UK companies use instead the 'financial position' form, but this still starts with assets presented in the order shown in Table 2.12.

Partly because it would have been difficult to reach international agreement, the IFRS on this subject (IAS 1) contains no requirements on formats; neither on the liquidity order nor on the shape. Traditional national practice survives under IFRS. For example, Australian companies still start with cash, whereas German IFRS reporters generally show it as the last asset. The existence of national versions of IFRS practice is discussed in Chapter 7.

International variation of balance sheets should not create many problems, except that a reader's attention may be drawn to different totals, e.g. total assets as opposed to net assets. The formats of Table 2.12 also do not show current liabilities separately, and it can be difficult to work out this total from the notes.

Table 2.11 Usual balance sheet formats

Country	Order of liquidity	Shape
Australia	Decreasing	Financial position
France	Increasing	Two-sided
Germany	Increasing	Report
Italy	Increasing	Two-sided
Japan	Decreasing	Two-sided
Spain	Increasing	Two-sided
United Kingdom	Increasing	Financial position
United States	Decreasing	Two-sided or report

Table 2.12 The evolution of the balance sheet (abbreviated versions)

1965 German AktG (§ 151)	1971 Draft Directive (Art. 8)	UK 1981 Act (Format 2)
Assets (shown on left)		
I Unpaid capital	A Unpaid capital	A Unpaid capital
	B Formation expenses	
II Fixed and financial	C Fixed assets	B Fixed assets
A Fixed and intangible	I Intangible	I Intangible
B Financial	II Tangible	II Tangible
	III Participations	III Investments
III Current assets	D Current assets	Current assets
A Stocks	I Stocks	I Stocks
B Other current	II Debtors	II Debtors
	III Securities	III Investments
		IV Cash
IV Deferred charges	E Prepayments	D Prepayments
V Accumulated losses	F Loss	
	I For the year	
	II Brought forward	
Liabilities and capital (shown on right)		
I Share capital	A Subscribed capital	A Capital and reserves
II Disclosed reserves	B Reserves	I Called up capital
		II Share premium
		III Revaluation reserve
		IV Other reserves
		V Profit and loss
III Provisions for diminutions	C Value adjustments	
IV Provisions for liabilities	D Provisions for charges	B Provisions for liabilities and charges
V Liabilities (4 years+)	E Creditors	C Creditors
VI Other liabilities		
VII Deferred income	F Accruals	D Accruals
VIII Profit	G Profit	
	I For the year	
	II Brought forward	

For income statements, the variety is rather more of a problem for users of financial statements. Table 2.13 shows the variety for some countries. The vertical/two-sided variation should not be a difficulty for users, although non-accountants may find the two-sided version hard to understand. The real problem lies in the two ways of combining costs: by nature or by function. The by-nature format combines costs as total purchases, total depreciation, total wages, etc. The by-function format combines costs by stage of production: cost of sales, administrative costs, distribution costs, etc. The by-function format allows the calculation of gross profit for a manufacturing company, whereas the by-nature format does not, because there is no information on the *manufacturing* wages, depreciation etc. that would be needed for the calculation of cost of sales.

Table 2.13 Usual income statements under national laws

Country	Shape	Cost combination
Australia	Vertical	Function
France	Two-sided	Nature
Germany	Vertical	Mixed
Italy	Vertical	Nature
Japan	Vertical	Function
Spain	Two-sided	Nature
United Kingdom	Vertical	Function
United States	Vertical	Function

Again, IAS 1 contains no requirement on formats. As is the case for balance sheets, some aspects of previous national practice survive into IFRS practice. For example, by-nature formats are more popular in Spanish IFRS practice than in British.

This chapter has discussed the connection between accounting and the predominance of outside shareholders. Shareholder orientation spreads further than accounting principles: it affects the format of financial statements. At its most obvious, the general use of a vertical format in the United Kingdom, rather than a horizontal format as in France or Spain, suggests a greater shareholder orientation in the United Kingdom. This is because, as noted above, the financial position format of the balance sheet allows the presentation of working capital and net worth, and it contrasts net worth with shareholders' funds. The vertical format of the income statement is easier to read for non-accountants.

However, even in the double-entry version of the balance sheet (see Table 2.9), the current continental European version has greater shareholder orientation than before. For example, it shows the elements of shareholders' funds together, rather than showing the year's net profit as a separate item at the bottom of the balance sheet (or a loss at the bottom of the assets side!) as did the 1965 *Aktiengesetz* (the German rules until 1987) and practice in Spain until 1989 and Italy until 1993. The greater continental interest in the double-entry aspects of the balance sheet was demonstrated by the presentation of 'provisions for bad debts' as a liability, and 'called up share capital not paid' as the first asset. The new formats introduced to implement the Fourth Directive removed many of these differences.

SUMMARY

- A large list of proposed causes of international accounting differences can be found in the literature.
- It seems very plausible that cultural differences affect accounting. Although efforts have been made to quantify culture, it is difficult to apply this to the measurement of accounting differences. More direct linkages can be established between accounting, legal and financing systems.

- Most countries considered in the book can be seen as either common law or codified law countries. There is some linkage with types of accounting.
- Countries with large equity markets need financial reporting suited to disclosing useful information to investors. Other countries are likely to have an accounting system linked to the calculation of taxable income and distributable income.
- Tax is very closely connected to financial reporting in several countries (e.g. Germany).
- External forces affect accounting in a country, particularly in the case of former colonies. An important external force is now the IASB.
- High levels of inflation have generally led to effects on accounting but they have differed by country. Theory seems to have little influence in most countries but, in the form of conceptual frameworks, is of increasing importance.
- International variations in the strength and size of the accountancy profession are very obvious, but they may be more a result than a cause of accounting differences.
- In summary, unless colonial influence overwhelms, an accounting system is most influenced by whether or not there is a strong equity market.
- Different degrees of conservatism can be found from country to country. Greater conservatism might be expected in countries where tax and accounting are closely linked and where there are conservative users such as bankers. One way of being more conservative is to make 'unnecessary' provisions. However, these can be reversed in bad years, thereby reversing the effects of conservatism on the earnings figure.
- The measurement of assets shows important international differences. Some countries require strict historical cost, others allow revaluations of selected assets at selected times. In several countries, governments have required controlled revaluations of fixed assets from time to time.
- The formats of financial statements differ markedly internationally. This leads to some difficulties for comparison. The degree of shareholder orientation in a country affects the formats of financial statements.

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

2.1* 'The basic cause of international differences in financial reporting practices is the different degree of interference by governments in accounting'. Discuss.

2.2* Assess the view that accidents of history are primarily responsible for international differences in corporate financial reporting.

2.3 If you were trying to predict which financial reporting regulations and practices would be found in various African countries, which non-accounting variables would you measure?

2.4 Explain how international differences in the ownership and financing of companies could lead to differences in financial reporting.

2.5 Do international differences in the rules for the calculation of taxable income cause accounting differences, or is the influence the other way round?

2.6 Why is it difficult to establish a causal relationship between specific external factors and international differences in accounting? Discuss the methodological problems in identifying possible causes.

2.7 How do the causal factors discussed in the chapter affect corporate governance structures in different countries?

2.8 Are the international differences in the formats of financial statements a major obstacle to comparing the statements?

3 International classification of financial reporting

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OBJECTIVES

After reading this chapter, you should be able to:

- explain why classification can be useful in the natural and social sciences and in the study of accounting;
- outline the classifications of national accounting systems that have been developed, distinguishing between those based on influences and those based on actual practices;
- show why it is important to be clear what is being classified: practices or regulations, regulations or regulatory systems, practices of all companies or only of listed companies, measurement practices or disclosure practices, countries or sets of financial statements;
- outline which countries can be classified with which others, depending on what is being classified;
- critically appraise the classifications in the literature.

3.1 Introduction

Chapter 2 discussed the causes and nature of international differences in financial accounting practices. Already it has been useful to note similarities between groups of countries, and to divide countries into two main classes for some purposes. This chapter is devoted to a more detailed examination of whether it is possible to classify countries by their accounting similarities and differences.

A major introductory point is that many countries now exhibit at least two systems of financial reporting, in addition to other accounting that may be done for tax or other private purposes. For example, in France, the consolidated statements of listed companies use IFRS whereas individual French companies, whether members of a group or not, use French national rules. So, it is now better to talk about classifying accounting systems rather than classifying countries.

The majority of the research work on classification was done in a period before this development, which relates particularly to 2005 onwards. Therefore, for readers only interested in the consolidated statements of listed companies, the older classification studies are primarily of historical interest. Nevertheless, in many countries the bulk of financial reporting (i.e. all unconsolidated statements and some consolidated statements) still follows domestic rules. So, international differences are still important. Even so, the domestic rules of some countries are themselves being harmonized with IFRS or US rules so the differences are becoming less dramatic. It is important to distinguish between this process of 'convergence' and the adoption of IFRS for certain purposes within a country. More subtly, international differences may survive in the form of different interpretations of IFRS or different choices of options.

In this chapter, it is useful to discuss first the nature of classification in natural sciences and social sciences. This is done in Sections 3.2 and 3.3, which are followed by an examination of the purpose of classification in accounting. It is possible to divide classifications into those based on external factors (Section 3.5) and those based on accounting practices (Sections 3.6 to 3.8). Section 3.9 examines the

literature on whether there really is an Anglo-Saxon group of countries. Section 3.10 asks whether there is still a purpose for classification in the IFRS era. Then, by way of summary, Section 3.11 presents a classification of the classifications.

Studying classification is a useful prelude to the study of harmonization (Chapter 4) and to the study of differences in domestic rules (Chapter 15).

3.2 The nature of classification

Classification should sharpen description and analysis; it should reveal underlying structures and enable prediction of the properties of an element based on its place in a classification. Classification may also provide an insight into what elements once existed, might exist in the future, or do exist and wait to be discovered.

One report suggested that four properties are necessary in a classification (AAA, 1977, pages 77–8). First, the characteristics of classification should be adhered to consistently. That is, throughout any classification the characteristics used as the means of differentiating one element from another should be the same. Different purposes for a classification will lead to the use of different characteristics. Secondly, a good classification will potentially contain sufficient subsets to exhaust a given universe. Thirdly, all subsets will be mutually exclusive in such a way that no element may fall into more than one of them. Last, hierarchical integrity should be observed; for example, in the Linnaean biological classification, any specific species of plant or animal is always in the bottom tier of the classification, always belongs to a genus, which always belongs to a family, and so on. Roberts (1995, pages 653–5) examines and criticizes these properties.

Different types of classification are possible, from the simplest form of dichotomous grouping (e.g. things black versus things white) or rank ordering (e.g. by height of students in a class) to more complex dimensioning (such as the periodic table) or systematizing (such as the Linnaean system). Two ways of grouping elements used in social science are 'multidimensional scaling' and 'morphological structuring'. The first uses two or more characteristics on different axes to try to find clusters of elements displaying similar characteristics. The second seeks to compose a 'morphology' that lists elements by important differentiating factors. It should then be clearer which elements are similar to each other (see, for example, Figure 3.1, overleaf).

3.3 Classifications by social scientists

Having briefly looked at the nature of classification and the techniques used to achieve it, we next examine traditional methods of classification in areas close to accounting. There have been classifications of political, economic and legal systems. For example, political systems have been grouped into political democracies, tutelary democracies, modernizing oligarchies, totalitarian oligarchies and traditional oligarchies (Shils, 1966). Economic systems have been divided into capitalism, socialism,

Parameters		*States of Nature*				
		1	*2*	*3*	*4*	*5*
P_1	Political system	Traditional oligarchy	Totalitarian oligarchy	Modernizing oligarchy	Tutelary democracy	Political democracy
P_2	Economic system	Traditional	Market	Planned market	Plan	
P_3	Stages of economic development	Traditional society	Pre-take-off	Take-off	Drive to maturity	Mass consumption
P_4	Objectives of financial reporting	← Micro →			← Macro →	
		Investment decisions	Management performance	Social measurement	Sector planning and control	National policy objectives
P_5	Source of, or authority for, standards	Executive decree	Legislative action	Government administration unit	Public–private consortium	Private
P_6	Education, training and licensing	← Public →		← Private →		
		Informal	Formal	Informal	Formal	
P_7	Enforcement of ethics and standards	Executive	Government administrative	Judicial	Private	
P_8	Client	Government	Public	← Enterprises →		
				Public	Private	

Figure 3.1 The AAA's morphology for comparative accounting systems

Source: Adapted from *Accounting Review*, Supplement to Vol. 52, page 99. Copyright © 1977 American Accounting Association, reproduced with permission of the American Accounting Association.

communism and fascism. Another classification is traditional economies, market economies and planned economies (Neuberger and Duffy, 1976). A more recent version of this was provided by Gregory and Stuart (2003).

Legal systems have also been classified (Kagan, 1955; Derrett, 1968; David and Brierley, 1985). One set of authors, while classifying legal systems, has supplied practical criteria for determining whether two systems are in the same group: firstly, systems are said to be in the same group if 'someone educated in . . . one law will then be capable, without much difficulty, of handling [the other]' (David and Brierley, 1985, page 21). Also, the two systems must not be 'founded on opposed philosophical, political or economic principles'. The second criterion ensures that systems in the same group not only have similar superficial characteristics, but also have similar fundamental structures and are likely to react to new circumstances in similar ways. Using these criteria a four-group classification of legal systems was obtained by David and Brierley: Romano–Germanic, Common Law, Socialist and Philosophical–Religious. Accounting researchers have used this sort of classification as an explanatory variable, usually dividing countries into two types: Roman and common (e.g. La Porta *et al.*, 1998).

In all the above examples, the type of classification used was rudimentary, involving no more than splitting systems into a few groups. The groups within the classifications were sometimes not precisely defined or exhaustive. Also, the method used to determine and fill the groups was little more than subjective classification based on personal knowledge or descriptive literature. These shortcomings are very difficult to avoid because of the complexity and 'greyness' in the social sciences.

The examination of classification in other fields, and how this might be relevant for accounting, is taken further in Nobes (2014, Chapter 2).

3.4 Classifications in accounting

It was suggested in Chapter 2 that the expression 'accounting system' would be used to mean the financial reporting practices used by a company. Systems could be classified into groups by similarities and differences. If all or most of the enterprises in a country use very similar accounting practices, this might suggest that countries can be classified on the basis of accounting practices. Even then, the system used in the country might change from year to year. In the discussion that follows, it becomes clear that various researchers have been trying to classify various objects, not necessarily accounting systems in the above sense.

The reasons for wanting to classify financial reporting 'systems' into groups include the general reasons for classification in any science, as outlined above. Classification should be an efficient way of describing and comparing different systems. It should help to chart the progress of a country as it moves from use of one system to another, and the progress of ideas of a dominant country's system by noting the other national systems grouped around it. The activity involved in preparing a classification (e.g. multidimensional scaling or morphological structuring, as referred to above) should encourage precision. Moreover, in the social sciences, classification may be used to help shape development rather than merely to describe how and why things are. For example, classification should facilitate a study of the logic of and the difficulties facing harmonization. This should be valuable both for academics and for those organizing harmonization, or measuring it (Doupnik, 1987). Classification should also assist in the training of accountants and auditors who operate internationally. Further, a developing country might be better able to understand the available types of financial reporting, and which one would be most appropriate for it, by studying a morphology and seeing which other countries use particular systems. Also, it should be possible for a country to predict the problems that it is about to face and the solutions that might work by looking at other countries in its group.

It has also been suggested that a way for a country to change from one accounting system to another may be to adjust the economic and political parameters to those more conducive to the desired system (AAA, 1977, page 100). However, this might seem like trying to wag a tail by moving the dog.

A proper understanding of accounting classifications is important for several reasons. Hundreds of academic papers refer to the classifications as part of motivating research (e.g. Gray, 1988; Ball *et al.*, 2000; O'Donnell and Prather-Kinsey, 2010) or to justify an independent variable (type of accounting system) which is expected

to influence issues such as value relevance (e.g. Ali and Hwang, 2000). Then, there are new uses for classifications: as explanations of which companies volunteer to adopt IFRS (Tarca *et al.,* 2013); how jurisdictions respond to IFRS (Sellhorn and Gornik-Tomaszewski, 2006; Tyrrall *et al.,* 2007); how countries change from one class to another (Xiao *et al.*, 2004); how practices on major topics vary over time (Ding *et al.*, 2008); how companies respond to the choices available in IFRS (Nobes, 2011); why the amount of lobbying on IFRS varies by country (Orens *et al.*, 2011); by how much various countries' domestic accounting requirements vary from IFRS (Ding *et al.*, 2007); or how to identify countries with similar backgrounds when selecting countries for study (Delvaille *et al.*, 2005). If the classifications are inappropriate, the research setting or the variables will be questionable.

For financial analysts, students and policy makers, the classifications are a convenient way of simplifying and summarizing. So, again, inappropriate classifications are likely to be misleading. For instance, much of the argumentation on the development of new standards is political (Harrison and McKinnon, 1986), and is now often expressed in terms of resisting 'Anglo-American' accounting. As an example, German writers have seen the international standard-setters as a Trojan horse that conceals Anglo-American accounting (Kleekämper, 2000) or as 'the unknown enemy from London' (Hennes and Metzger, 2010). Botzem and Quack (2009) believe that the history of the IASC has been wrongly reported as 'an Anglo-American success story' (page 991). However, as will be shown, some classifiers deny the existence of Anglo-American accounting.

The next section contains a summary of some classification attempts based on observing characteristics that might influence accounting practices rather than on the practices themselves. Such classifications may be called 'extrinsic'. Of course, different conclusions about which of these factors are important (see Chapter 2) will lead to different classifications. By contrast, 'intrinsic' classifications are based on accounting itself.

Whether a classification is extrinsic or intrinsic depends on what is being classified. For example, one of the classifications described as extrinsic in the next section concerns regulatory systems. This is because the central subject matter here is the financial reporting practices of companies and the content of the rules that control them. These are influenced by economic and other factors, and they operate within regulatory systems. By contrast, in the context of a chapter focused on regulatory systems, a classification based directly on the nature of those systems would be intrinsic.

Several of the so-called 'intrinsic' studies of Sections 3.6–3.8 are also one step removed from financial reporting *practices* because they are based on the content of the rules of reporting rather than on the practices. Again, it is helpful to focus on what is being classified. In many cases, the objects of classification are countries, and they are classified by the nature of the financial reporting rules/practices of a set of companies. As explained later, it would be better to classify financial reporting systems themselves, and to do so by their key characteristics.

Table 3.1 summarizes 16 accounting classifications. As may be seen, the number of countries varies from 2 to 64. The number of topics (or characteristics) measured ranges from 1 to 264. Many of these 16 classifications are discussed below; they are all examined by Nobes and Stadler (2013).

Table 3.1 Features of some classifications

	1. Researchers	2. Number of countries	3. Range of companies (e.g. sectors, large, listed)	4. Date of data	5. Number of topics	6. Type of data	7. Classification method	8. Classification type
1.	Hatfield, 1966	4	Unspecified	Unspecified, c. 1910	0	Impressions of practices	Judgement	3 groups
2.	Mueller, 1967	5	Unspecified	Unspecified, c. 1965	1	Impressions of purposes	Judgement	4 unconnected groups
3.	Seidler, 1967	13	Unspecified	Unspecified, c. 1965	1	Impressions of influences	Judgement	4 unconnected groups plus other mentioned countries
4.	AAA, 1977	6	Unspecified	Unspecified, c. 1975	1	Impressions of influences	Judgement	5 unconnected groups
5.	Da Costa *et al*., 1978	38	Unspecified	Unspecified, c. 1973	100	Mixture of rules and impressions of practices (by Price Waterhouse partners)	PCA	2 unconnected groups
6.	Frank, 1979	38	Unspecified	Unspecified, c. 1973	233	As above	PCA, MDS	4 unconnected groups
7.	Nair and Frank, 1980	38, 46	Unspecified	Unspecified, c. 1973 and c. 1975	233, 264	As above	PCA, SSA	4/5 unconnected groups for measurement; 7 for disclosure
8.	Goodrich, 1982	64	Unspecified	Unspecified, c. 1979	26	Impressions of concepts (by Price Waterhouse partners)	PCA	5 unconnected groups
9.	Nobes, 1983	14	Listed	1980	9	Impressions of practices	PCA	Hierarchy of 2 groups, leading to 6 groups

(Continued)

Table 3.1 Features of some classifications *(Continued)*

	1. Researchers	2. Number of countries	3. Range of companies (e.g. sectors, large, listed)	4. Date of data	5. Number of topics	6. Type of data	7. Classification method	8. Classification type
10.	Puxty *et al.*, 1987	4	Unspecified	Unspecified, c. 1985	3	Impressions of regulatory style	Judgement	Positions of the countries with respect to three regulatory ideals
11.	Shoenthal, 1989	2	Unspecified	Unspecified, c. 1987	1	Impressions of competencies of auditors	Judgement	2 unconnected groups
12.	Doupnik and Salter, 1993	50	Economically significant entities	1990	114	Impressions of practices (by academics and auditors)	Average-linkage clustering	Hierarchy of 2 groups, leading to 9 groups
13.	D'Arcy, 2001	14 + IASC	Listed; consolidated and unconsolidated	Unspecified, based on Ordelheide and Semler (1995)	129	Rules	Clustering, MDS	4 groups with MDS
14.	Leuz *et al.*, 2003	31	Listed	Based on La Porta *et al.*, 1998	9	Facts and impressions relating to stock markets and investor protection	Clustering by k means	3 groups in order
15.	Leuz, 2010	37, 49	Listed	'2000s'	13	Facts and impressions on legal system, securities regulation	Clustering by k means	3 groups, then 5 groups
16.	Nobes, 2011	8	Large, listed, consolidated, excluding financials for some topics	2008/9	13	Practices	PCA, MDS, clustering	3 groups by PCA; hierarchy starting with 2 groups

Notes: PCA = principal component analysis. MDS = multi-dimensional scaling. SSA = smallest space analysis.
Source: Nobes, C.W. and Stadler, C. (2013) How arbitrary are international accounting classifications? Lessons from centuries of classifying in many disciplines, and experiments with IFRS data, Accounting, Organizations and Society, Vol. 38(8), pp. 573–95.

3.5 Extrinsic classifications

3.5.1 Mueller's classifications

In the late 1960s, Professor Gerhard Mueller broke new ground by preparing international classifications of accounting (Mueller, 1967) and of business environments (Mueller, 1968). His classification of accounting systems into four patterns of development is a simple grouping that is not accompanied by an explanation of the method used to obtain it. However, the 'range of four is considered sufficient to embrace accounting as it is presently known and practised in various parts of the globe' (Mueller, 1967, page 2). Each group is illustrated by one or two examples. Perhaps it is not reasonable to expect a more sophisticated classification in a pioneering work, and perhaps Mueller's informed judgement was one of the best methods of classification available.

Mueller stresses that the types of accounting rules that exist in a country are a product of economic, political and other environments, which have determined the nature of the system. This also suggests that other countries' rules would not be appropriate to that country and that rules must be chosen to fit a country's needs. Consequently, doubt is cast on the possibility and usefulness of harmonization. Mueller's four groups, which are usefully summarized in a later work (Choi and Meek, 2005, Chapter 2) are as follows:

1 *Accounting within a macroeconomic framework*. In this group, accounting has developed as an adjunct of national economic policies. We might expect such financial accounting to stress value added statements, to encourage income smoothing, to be equivalent to tax accounting and to include social responsibility accounting. Sweden was said to be an example.

2 *The microeconomic approach*. This approach can prosper in a market-oriented economy that has individual private businesses at the core of its economic affairs. The influence of microeconomics has led accounting to try to reflect economic reality in its measurements and valuations. This means that accounting rules must be sophisticated but flexible. Developments such as replacement cost accounting will be accepted most readily in such systems. The Netherlands was suggested as an example.

3 *Accounting as an independent discipline*. Systems of this sort have developed independently of governments or economic theories. Accounting has developed in business, has faced problems when they arrived and has adopted solutions which worked. Theory is held in little regard and turned to only in emergencies or used *ex post* in an attempt to justify practical conclusions. Expressions such as 'generally accepted accounting principles' are typical. Mueller recognized the accounting systems of the United Kingdom and the United States as examples.

4 *Uniform accounting*. Such systems have developed where governments have used accounting as a part of the administrative control of business. Accounting can be used to measure performance, allocate funds, assess the size of industries and resources, control prices, collect taxation, manipulate sectors of business, and so on. It involves standardization of definitions, measurements and presentation. France was cited as an example.

Mueller was not classifying financial reporting systems directly, on the basis of differences in *practices*, but indirectly, on the basis of differences in the importance of economic, governmental and business factors in the development of particular systems. However, one might expect that systems that have developed in a similar way would have similar accounting practices. To an extent, this is true. Chapter 2 of this book has suggested that the United Kingdom and United States have somewhat similar accounting practices; Mueller's developmental classification also puts them together.

Nevertheless, there are a few problems with Mueller's classification. The fact that there are only four exclusive groups and no hierarchy reduces the usefulness of the classification. The Netherlands is the only country in one of the groups and the classification does not show whether its accounting is closer to Anglo-Saxon accounting than it is to Swedish accounting. Similarly, the classification cannot include such facts as that German accounting exhibits features that remind one of macroeconomic accounting as well as uniform accounting. Communist accounting was left out entirely, but this may, of course, be sensible if the classification is dealing with published financial reporting, because there was none in communist countries.

Another problem has developed over time, which is that the classification is now out of date. For example, Sweden moved towards Anglo-American accounting, particularly in the 1990s; and the Netherlands largely abandoned its replacement cost accounting. However, Mueller's classification remains of historical importance.

Mueller's second classification (1968) is of business environments. He makes the point that different business environments need different accounting systems and that this should be considered when trying to change or standardize accounting. Using estimates of economic development, business complexity, political and social climate and legal system, Mueller identifies 10 groupings. This is not a classification of financial reporting and is perhaps too general to be of help in such a classification. For example, one group – 'the developing nations of the Near and Far East' – might be argued by some to *need* similar accounting systems, but it certainly did not have them.

3.5.2 Morphologies

It has been mentioned that one way to obtain a classification is to draw up a morphology and to use empirical data with this to obtain clustering. Morphologies of accounting practice have been drawn up by Buckley and Buckley (1974) and by the AAA (1977, page 99). The AAA's is reproduced as Figure 3.1. Although such parameters as the first two (political and economic systems) may seem less relevant than actual characteristics of accounting practice, it may well be important to include them in order to avoid misclassification based on temporary superficial similarities. As the AAA's Committee on International Accounting notes, 'Parameters . . . P_1 and P_2 are viewed as being pivotal to the type of accounting system which does (or can) emerge' (page 97). Unfortunately, these morphologies were not taken further by combining them with empirical data.

3.5.3 Spheres of influence

There have been some 'subjective' classifications based on 'zones of influence'. Seidler (1967) suggested three groups: British, American and continental European. Also, the

AAA's committee produced a subjective classification of five 'zones of influence' on accounting systems (AAA, 1977, pages 105 and 129–30). These are as follows:

1 British;
2 French–Spanish–Portuguese;
3 German–Dutch;
4 US;
5 Communist.

This classification is perhaps most useful in the context of developing countries, where cultural influences from elsewhere may be overwhelming, as discussed in Chapter 2. However, it has no hierarchy and thus does not take account, for example, of the links between British and US accounting. Further, to call a group 'German–Dutch' seems inappropriate as a way of classifying developed financial reporting systems when examined in the light of the material in Chapters 2 and 13.

3.5.4 Cultural classification

As noted in Chapter 2, Gray (1988) uses Hofstede's (1980) cultural work in order to propose explanations for international differences in accounting practices. Clearly, a cultural classification could then be used to propose an accounting classification, and Gray (1988, pages 12 and 13) makes preliminary suggestions along those lines. Others (e.g. Doupnik and Salter, 1995) also make use of Hofstede's factors in the context of accounting classification.

It was suggested in Chapter 2 that it may be more useful to see culture as a background influence on the causes of international accounting differences. This idea is taken up later in this chapter.

3.5.5 Classification of accounting by regulatory style

Puxty *et al.* (1987) use the work of Streeck and Schmitter (1985) to suggest that there are three limiting and ideal cases of regulation: through the 'market', the 'state' and the 'community'. If the process is left entirely to market forces, each company chooses its own rules, influenced only by pressures from, in particular, the capital market. To some extent this was the position in the 'unregulated economy' of nineteenth-century Britain, and in the United States before the establishment of the SEC, where some companies voluntarily published accounting information and subjected themselves to audit (Watts and Zimmerman, 1983). At another extreme, the whole process can be in the hands of the 'state', organs of which may decree the practices to be followed and provide an enforcement mechanism. As we shall see later, this can be accomplished in a number of different ways. The third ideal case is the emergence of rules through the 'spontaneous solidarity' of the community.

Within these three extremes, Puxty *et al.* distinguish what they and others term 'liberalism', 'associationism', 'corporatism' and 'legalism'. As Figure 3.2 shows, in accounting regulation the market and the state have predominated over the community. The four modes of Puxty *et al.* form a continuum: at one extreme is liberalism, whereby regulation is provided exclusively by the discipline of the market,

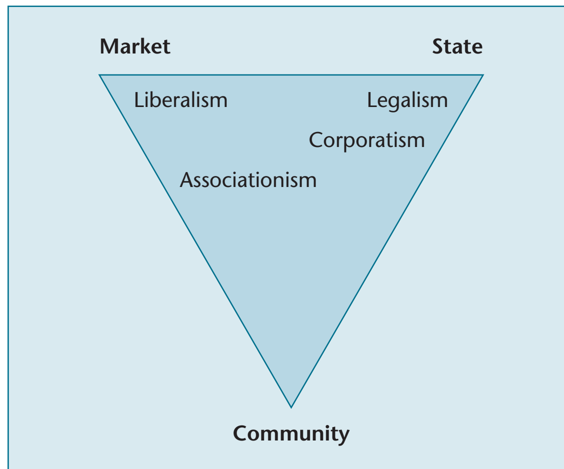

Figure 3.2 Regulation of financial reporting

Source: Adapted from Modes of regulation in advanced capitalism: locating accountancy in four countries, *Accounting Organizations and Society*, Vol. 12(3), page 283 (Puxty, A.G., Willmott, H.C., Cooper, D.J. and Lowe, A.E., 1987), Copyright © 1987 Elsevier Science, reproduced with permission of Elsevier.

while companies provide information only if it is demanded commercially; at the other is legalism, which relies upon the unreserved application of state principles. Accounting practice is expected to follow the letter of the law, which is enforced by the state's monopoly of the means of coercion.

Within these two extremes are associationism and corporatism, both of which combine liberalism and legalism with a small dose of community influence. In associationism, regulation is accomplished through the development of organizations that are formed to represent and advance the interests of their members. These members form, of course, part of the community but do not represent it as a whole. Corporatism involves a greater reliance upon the state principle of hierarchical control. The state does not simply license the existence of organized interest groups but incorporates them into its own centralized, hierarchical system of regulation. The basic difference between corporatism and associationism is the extent to which the state 'leans' on interest groupings to achieve public (i.e. state), as contrasted with private (i.e. market), purposes.

Puxty *et al.* apply this framework to the United States, the United Kingdom, Germany and Sweden, as follows:

- *United States*: elements of legalism and associationism, with the latter subordinated to the former;
- *United Kingdom*: principally associationist;
- *Germany*: legalism predominant;
- *Sweden*: corporatism.

Chapters 8, 14 and 20 of this book examine the regulatory systems in three of these (and other) countries. International differences in regulatory systems have largely survived the harmonization of accounting. A classification by regulatory style was suggested by Nobes (1992a, pages 99–103).

3.5.6 Regulatory variables

Related to the above, Leuz (2010) provides a classification of countries based on regulatory variables that might affect the quality of accounting. These include:

- large stock market;
- low ownership concentration;
- strong rights of outside shareholders;
- strong legal enforcement.

Table 3.2 shows such a classification. Countries in 'Cluster 1' generally score highly on all of the above four variables.

In 2006, the World Bank published an index of investor protection regulations in 81 countries. Matoussi and Jardak (2012) explain the international variation in this, using legal, cultural and political variables. They show a connection between a country's investor protection index and the size of market capitalization.

Table 3.2 Cluster membership using regulatory variables

Cluster 1	Cluster 2	Cluster 3
Australia	Austria	Argentina
Canada	Belgium	Brazil
Hong Kong	Chile	Colombia
India	Denmark	Ecuador
Ireland	Finland	Egypt
Israel	France	Indonesia
Malaysia	Germany	Jordan
New Zealand	Greece	Kenya
Singapore	Italy	Mexico
South Africa	Japan	Nigeria
Taiwan	Korea (South)	Pakistan
Thailand	Netherlands	Peru
United Kingdom	Norway	Philippines
United States	Portugal	Sri Lanka
	Spain	Turkey
	Sweden	Uruguay
	Switzerland	Venezuela
		Zimbabwe

Source: Adapted from Leuz, C. (2010) 'Different approaches to corporate reporting regulation: how jurisdictions differ and why', *Accounting and Business Research*, Vol. 40, No. 3, pp. 229–56.

3.5.7 Competencies of auditors

Shoenthal (1989) purports to show that the skills of newly qualified auditors in the United Kingdom and the United States could be used as a classifying variable. However, there must be doubt whether this variable picks up anything relevant; and a two-country study can tell us nothing about classification except that the two countries are different (Nobes, 1992b; Shoenthal, 1992).

3.6 Intrinsic classifications: 1970s and 1980s

3.6.1 Introduction

Some researchers have tried to classify by measuring accounting directly, either using the data collected by others or by generating their own. In most of these cases, the data relate to accounting rules (or to a mixture of rules and practices) rather than to accounting practices alone. However, even the data on practices relate to the opinions of auditors about practices rather than being a measure of practices based on samples of real company reports.

An early attempt at classification and some more recent descriptions of different national systems form the background to modern intrinsic classifications. First, a three-group classification (United Kingdom, United States and Continental) was suggested at the beginning of the twentieth century (Hatfield, of 1911 but published in 1966). Other descriptions and analyses, such as those by Zeff (1972), Price Waterhouse (1973, 1975 and 1979), AICPA (1964 and 1975), Coopers & Lybrand (1993), Alexander and Archer (2001) and Ordelheide and KPMG (1995 and 2001), provide the raw material for intrinsic classification.

3.6.2 Classifications using clustering

This sub-section examines three classifications that used data about accounting rules and practices published by Price Waterhouse (1973 and 1975; hereafter PW). The 1973 *Survey in 38 Countries* scores each country on 233 accounting topics. The scores are based on whether a particular practice is required, allowed or banned. For those practices allowed, an indication is given of how common they are. Although this data set is a mixture of rules and practices, it can be taken as a score of practices, assuming that companies are complying with the rules.

Da Costa, Bourgeois and Lawson (1978) produced a classification based on the PW 1973 data. Clustering produced two groups: one contained the United Kingdom and nine former members of the British Empire; the other contained the United States, France, Germany, South American countries, and all others except for the Netherlands and Canada, which were said to be unclassifiable.

Another researcher (Frank, 1979) used the same data and similar (though more elaborate) analysis, but produced what seems to be a much more reasonable classification, e.g. in which Canada and the US are together, and not with France. This work was extended by Nair and Frank (1980). Here the 1973 and the 1975 PW Surveys are used, and the financial reporting characteristics are divided into those relating to measurement and those relating to disclosure. This is a useful differentiation, particularly because of the effect it has on the classification of countries such as Germany that had advanced disclosure requirements. Frank (1979) classified Germany in a 'US group' but, by using 'measurement' characteristics only, Nair and Frank (1980) classify Germany in the 'continental European' group. Table 3.3 represents the classification using 1973 measurement characteristics. As yet there is no hierarchy, but the overall results do seem plausible and fit well with the analysis in previous chapters of this book. However, there are two major types of problem with these classifications that must now be dealt with, relating to the data and the methodology.

Table 3.3 Classification based on 1973 measurement practices

British Commonwealth model	Latin American model	Continental European model	United States model
Australia	Argentina	Belgium	Canada
Bahamas	Bolivia	France	Japan
Eire	Brazil	Germany	Mexico
Fiji	Chile	Italy	Panama
Jamaica	Colombia	Spain	Philippines
Kenya	Ethiopia	Sweden	United States
Netherlands	India	Switzerland	
New Zealand	Paraguay	Venezuela	
Pakistan	Peru		
Rhodesia	Uruguay		
Singapore			
South Africa			
Trinidad and Tobago			
United Kingdom			

Source: Adapted from The impact of disclosure and measurement practices on international accounting classifications, Accounting Review, Vol. 55(3), page 429 (Nair, R.D. and Frank, W.G., 1980), © American Accounting Association, reproduced with permission of the American Accounting Association.

The data

Doubts have been expressed about the use of the PW data for the purpose of classification (Nobes, 1981). Four types of problem with the 1973 data were noted: (i) straightforward mistakes; (ii) misleading answers; (iii) swamping of important questions by trivial ones; and (iv) exaggeration of the differences between the United States and the United Kingdom because of the familiarity of these countries (and thus their differences) to the compilers of the survey questions. The examples from the 1973 survey will not be repeated here, but an error in the 1979 survey will be mentioned.

Taking consolidation practices as an example, the survey reported that for practice 209 ('consolidated statements . . . are prepared for the shareholders') the answer was 'required' in France. The reason given for this was that the *Commission des Opérations de Bourse* (COB) 'requires' consolidation. However, as the Annual Reports of the COB showed, only 305 listed companies published consolidated balance sheets and income statements in 1979 (289 in 1978). This is less than half of the listed companies, and a very much smaller proportion of 'enterprises which issue their statements to the general public', about which the survey was said to be constructed (PW, 1979, page 5).

These examples could be replicated many times over. They suggest that, at some points, the surveys reported not on actual practices but on what practices might have been if non-mandatory rules had been obeyed, or on what PW partners might have liked practices to have been. This and the other types of error suggest that the data were unsatisfactory for the purposes of classification. At the least, substantial caution is called for when interpreting the results.

The methodology

All the researchers cited above use cluster analysis based on the PW data and appear to consider this to be superior to previous subjective classifications. Nair and Frank state (1980) that their research is '. . . aimed at empirically assessing the validity of international classifications proposed repeatedly in the accounting literature' (page 449).

This version of 'empiricism' must be challenged. It does not directly test a particular hypothetical classification. It classifies a mass of data that was not collected for the purpose of classification. The use of this approach leads one of the sets of researchers referred to above (Da Costa *et al.*, 1978, page 79) to conclude that the country least like the UK group is the United States; in other words, accounting in Uruguay or Ethiopia was considered more like accounting in the United Kingdom than accounting in the United States was. While this may have been a statistically sound result from the PW data, it was clearly an inaccurate representation of the real world (see Section 3.9). The researchers, who were generating a hypothesis from doubtful data rather than testing one, fell into the trap of taking their results seriously. This led them to conclude that a group of countries containing France, Germany, Belgium and Italy, among others, 'follows the lead of the United States in dissociating itself from practice common to the British model'. However, it seems highly unlikely that the makers of the company and tax laws that govern accounting in such countries bore in mind either that they should follow the United States or that they should dissociate themselves from the United Kingdom when legislating. The differences between the United States and continental European countries are known to have been great, and also suggest that there was no accidental or subconscious 'following' of the former by the latter (Chapter 15).

The problem that these examples illustrate stems from the use of data that contained errors and that were not designed for the purpose in hand. Turning to the Linnaean biological system for an analogy, to the extent that judgement and empiricism can be counterposed, the life scientists use a large measure of the former. Exactly which criteria to use for a classification of living things, and what weight to give them, is a matter of judgement. Judgement is needed to avoid such classifications as Plato's of man as a featherless biped. In fact, man is not now seen to be close to birds but to be much more closely related to most quadrupeds, and to dolphins which appear to have no feet at all. Aristotle saw this latter distinction. He referred to 'homologs', where objects similar in structure play different roles (e.g. human feet and dolphins' flippers), and to 'analogs', where similar functions are performed by quite different objects (e.g. birds' wings and bees' wings, which have entirely different structures, the former being 'arms'). It is the homologs that indicate nearness in relationship.

Looking in more detail at the Linnaean biological classification we can note that, when classifying animals, biologists largely ignore the most obvious characteristics; that is, they do not carry out factor analysis on animals by weight, colour, number of legs, nature of body covering, length of life, etc. This would merely lead to a classification of those data. It would put men with ostriches, dolphins with sharks, bats with owls, and so on. In fact, by concentrating on a subjective model that involves underlying (but less obvious) characteristics, biologists classify men, dolphins and bats more closely with each other than with any of the other three types of animal. It is then found that behaviour, intelligence, reproduction and ancestry begin to fit with the classification. The biological scientists, then, use a classification which is evolutionary and concentrates on underlying fundamental variables.

It should also be noted that botanists have had greater difficulties than zoologists. This perhaps is partly due to the lack of skeletons and comparative lack of fossil remains to study. The modern approach to biological classification includes an analysis of the degree of similarity of the DNA of various organisms.

The analogy with classification in accounting seems clear. The danger with 'empirical' classifications is that one merely classifies data that concentrate on differences that may be ephemeral and superficial (and that may not be correctly recorded). The need is apparent for a model based on the evolution of accounting practices and upon variables that have caused differences in them. This would then have to be checked against carefully measured 'structural' practices; and one would have to be clear about the purpose of the classification.

3.6.3 Classification using a model and new data

Thus, it would be possible to criticize previous classifications for (a) lack of precision in the definition of what is to be classified; (b) lack of a model with which to compare the statistical results; (c) lack of a hierarchy that would add more subtlety to the portrayal of the size of differences between countries; and (d) lack of judgement in the choice of 'important' discriminating features. Can these problems be remedied? One of the authors attempted to solve them in his own researches (Nobes, 1983), as explained below.

Definition

The purpose of the research was defined as the classification of countries by the financial reporting practices of their *public companies*. The countries chosen were those of the *developed Western world*; the reporting practices were those concerned with *measurement and valuation*. The date of the classification was 1980, before the implementation in EU countries of the Fourth Directive on Company Law (see Chapter 13).

It is public companies whose financial statements are generally available and whose practices can be most easily discovered. It is the international differences in reporting between such companies that are of interest to shareholders, creditors, auditing firms, taxation authorities, managements and harmonizing agencies (such as the International Accounting Standards Board or the European Commission) (Mason, 1978, Chapter 5). It was really only in developed countries that public companies existed in large numbers. However, it would be possible to include more countries by widening the definition of accounting. To some extent this has been tried (Nobes, 1992a, Appendices V and VI; Nobes, 2014, Appendix II).

Measurement and valuation practices were chosen because these determine the size of the figures for profit, capital, total assets, liquidity and so on. Nair and Frank (1980, pages 426 and 428) point out that it is useful to separate measurement from disclosure practices.

A model with a hierarchy

The hypothetical classification similar to that shown in Figure 3.3 was based on some explanatory variables for differences in measurement practices; for example, the importance of the influence of law, or of economics. Some descriptions are included at the branching points in Figure 3.3.

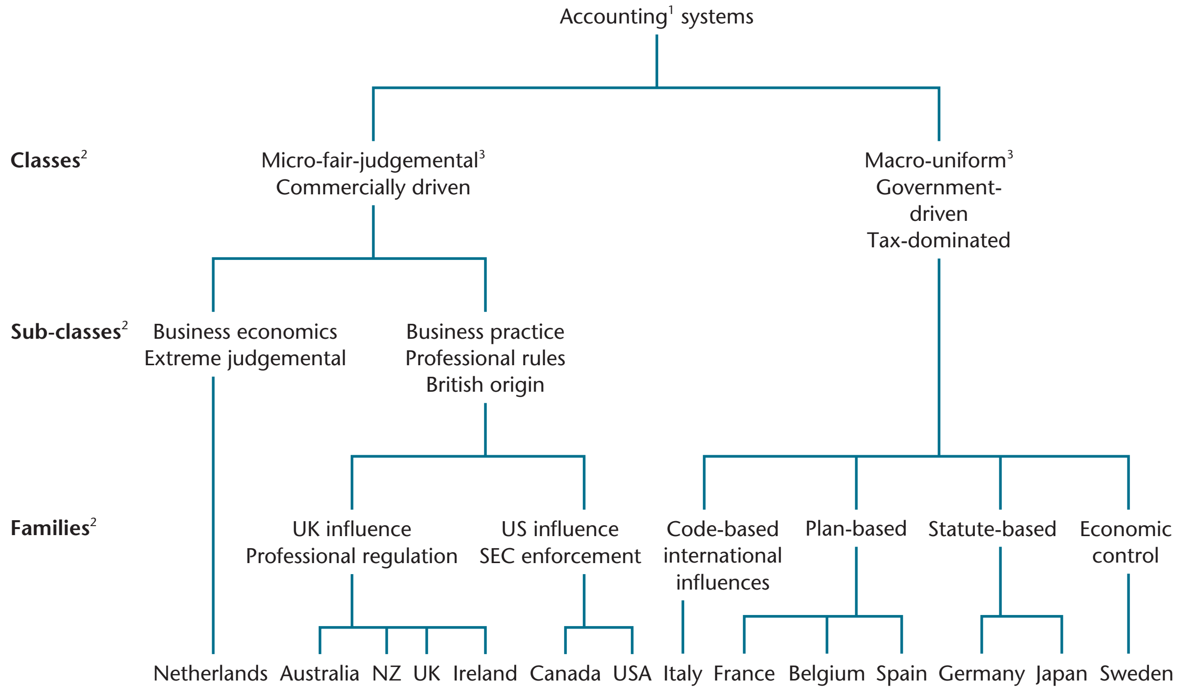

Figure 3.3 A suggested classification of accounting 'systems' in some developed Western countries in 1980

Notes:
[1] This is an abbreviated term for corporate financial reporting.
[2] These terms, borrowed from biology, should be interpreted merely as loose labels.
[3] The terms at these and other branching points are merely labels to be used as shorthand to try to capture some of the attributes of the members of the accounting systems below them. This classification has been prepared by a UK researcher and may contain usage of terms that will mislead those from other cultures.

The number of countries is kept to 14. All these are developed nations for reasons noted above; they are all included in the PW surveys and thus in the results of the researchers referred to earlier; and they include all the countries identified as 'vital' by Mason (1978) for the purposes of international harmonization (i.e. France, Japan, Netherlands, the United Kingdom, the United States and Germany).

Previous classifications contained separate groups (e.g. Table 3.3) but no hierarchy that would indicate the comparative distances between the groups. It may be reasonable to classify the United Kingdom and the United States in different groups, but it might be useful to demonstrate that these two groups are closely linked compared with, say, continental European countries.

Discriminating features

An attempt was made to isolate those features of a country's financial reporting practices that may constitute long-run fundamental differences between countries. The result was a selection of nine factors that, unlike the factors of most of the researchers above, are overt and thus available for inspection, criticism and amendment (see Table 3.4).

Table 3.4 Factors for differentiation

1	Type of users of the published financial statements of listed companies
2	Degree to which law or standards prescribe in detail and exclude judgement
3	Importance of tax rules in measurement
4	Conservatism/prudence (e.g. valuation of buildings, inventories, debtors)
5	Strictness of application of historical cost (in the main statements)
6	Susceptibility to replacement cost adjustments in main or supplementary statements
7	Consolidation practices
8	Ability to be generous with provisions (as opposed to reserves) and to smooth income
9	Uniformity between companies in application of rules

These factors were designed to be relevant for developed countries which share certain economic features. If one wished to include developing countries, it would be necessary to include other discriminating factors, such as the degree of development of economy or nature of economic systems. But such a process might not be sensible because there are few or no public companies in some of these other countries, so that one would have to classify something other than published financial reporting.

It is not a straightforward matter to separate measurement practices from explanatory variables. However, it is clear that at least the first two factors in Table 3.4 were examples of explanatory variables. Other factors were less clear. For example, the 'taxation' factor could have been taken as a factor explaining differences or, by asking whether particular valuations were affected by tax rules, it could have been seen as a measurement practice. All the factors except the first two were taken in this latter sense. For this reason, this classification is considered here to be intrinsic. Nevertheless, this choice of factors can be criticized as mixing extrinsic and intrinsic topics.

The 14 countries were scored on these nine factors, and then a large number of alternative arithmetical and computer-based tests were used to produce clusters. Very strong support was found for the 'micro/macro' split in Figure 3.3; and considerable support for the more detailed groupings (Nobes, 1983).

3.7 Developments related to the Nobes classification

3.7.1 Classification by degree of standardization

Further classification work has been carried out by Al Najjar (1986), using a similar approach to Nobes (1983) but applying it to a classification of countries by degree of standardization of accounting.

3.7.2 Tests

Doupnik and Salter (1993) tested the Nobes classification using their own assessments of accounting practices, based on the impressions of auditors in different countries. One of the problems with this is that the data used to 'test' the 1980 classification relate to 10 years after it. Later, Doupnik and Salter (1995) suggest a general model about the

causes of accounting differences, proposing 10 variables. However, some of the variables seem misspecified, and some seem to overlap with others. For example, Doupnik and Salter use a tax variable, measured on the basis of marginal tax rates, as a proposed cause of accounting differences. Chapter 2 of this book suggests that the international variation in the relationship between tax and accounting is more of a *result* of accounting differences than a *cause* (see Nobes, 1998a for more detail). Further, the use of marginal rates seems an inappropriate measure because of the following:

- Tax rates change dramatically over time without any obvious effect on accounting. For example, the top US tax rate fell from 46 per cent to 34 per cent in 1987; and the main rate in the UK rose in 1973 from 40 per cent to 52 per cent, and fell to 26 per cent for 2011/12, and to 20 per cent by 2015/16.
- Many systems have more than one tax rate (e.g. in Germany in 2000, 45 per cent for retained profit but 30 per cent for distributed profit; and, in the UK in that year, 26 per cent for large companies but 20 per cent for small).
- The tax burden depends greatly on the definition of 'taxable income', not just on the tax rate.
- More importantly, in countries with a small connection between tax and accounting, the tax rate will have little effect on accounting; and in countries with a close connection, the effect of tax on accounting will be in the same direction and probably almost as strong, whether the rate is 30 per cent or 50 per cent.

Despite these difficulties, Doupnik and Salter's papers provide a large degree of support for the classification in Figure 3.3, particularly for the initial two-class split. As will be explained in Section 3.10, the classification retains relevance even in a world dominated by international standards.

3.7.3 Improvements

The classification in Figure 3.3 contains a hierarchy that borrows its labels from biology. This can be criticized (see below), as can the conflation of Mueller's labels 'macro' and 'uniform' (Feige, 1997a; Nobes and Mueller, 1997; Feige, 1997b). Part of the problem here is that Nobes's classification, like Mueller's, is now historical, although elements of it might survive an update.

Roberts (1995) makes a number of criticisms and clarifications relating to accounting classifications. He points out that the classification in Figure 3.3 is not really evolutionary, although its analogies with biology and use of labels such as 'species' suggest this. Also, the objects being classified appear to be countries, which seems misleading.

In order to improve upon Figure 3.3, we might make it clearer that the classification concerns accounting systems, i.e. the financial reporting practices of a particular company in an annual report. It is possible for all companies in a country at a particular date to be using the same system, or for several different systems to be in use. The most contentious labels (e.g. 'species') will be abandoned and we will admit that the classification is not evolutionary – as indeed the Linnaean system was not originally.

Figure 3.4 shows the classification of some financial reporting systems, as adapted from Nobes (1998a). Some explanation of certain features may be useful. For example, the system 'US GAAP' means the well-defined set of practices required by US

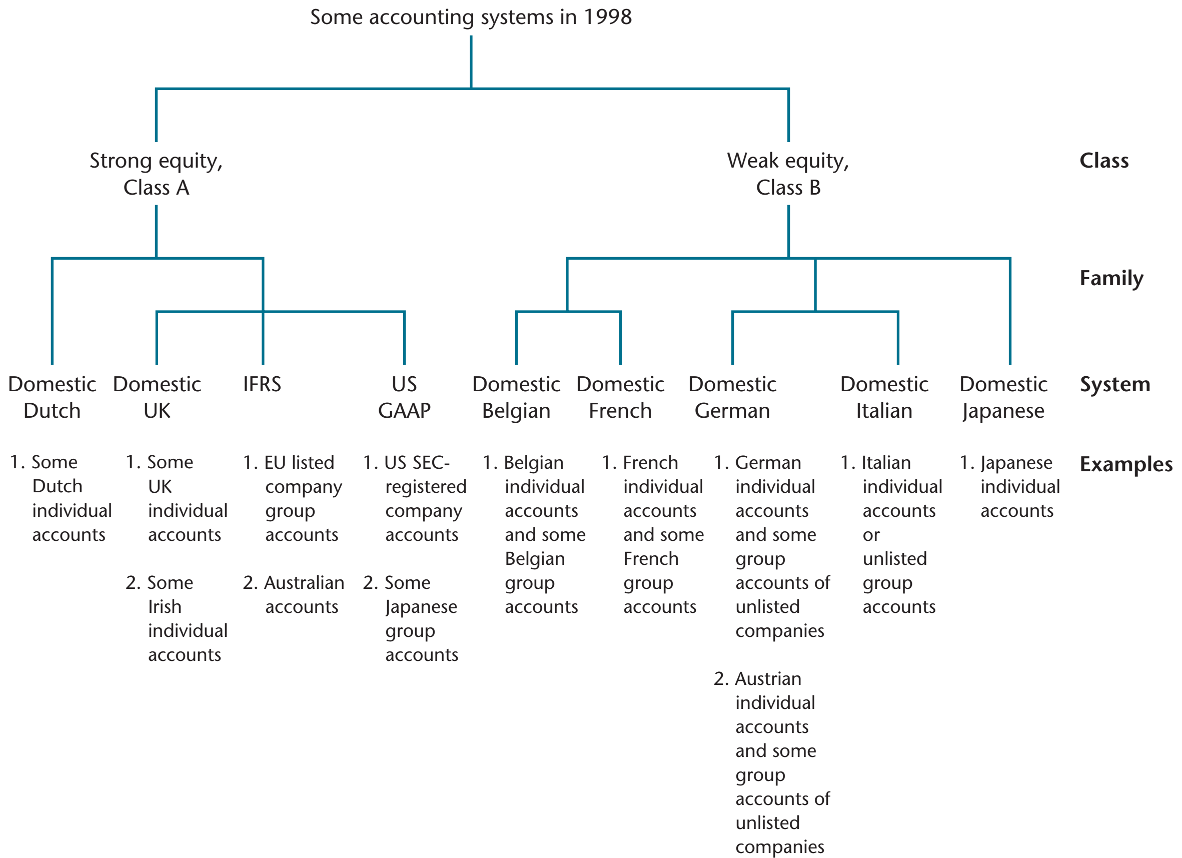

Figure 3.4 Proposed scheme for classification

Source: Adapted from Nobes, C.W. (1998) Towards a general model of the reasons for international differences in financial reporting, Abacus, Vol. 34(2), pp. 162–187. Copyright © 2002, John Wiley and Sons

regulators to be used by certain US companies (see Chapter 8). Of course, the system changes somewhat over time. Examples of users of the system are SEC-registered US companies, and certain large Japanese companies for their group statements (see Chapter 11). The figure suggests that 'US GAAP' bears a family resemblance to UK and IFRS rules (see Chapters 2 and 6), and is in a class of systems suited to strong equity markets. Hellman *et al.* (2015) provide evidence to support the classification, by measuring the size of the change needed in various countries when companies moved from national GAAPs to IFRS, particularly in 2005.

3.8 Further intrinsic classification

3.8.1 New data, new classifications

D'Arcy (2001) used the data drawn from Ordelheide and KPMG (1995; hereafter OKPMG) to produce classifications including a dendrogram based on cluster analysis in which 'an Anglo-American cluster, including the UK and the US cannot be found'

(page 341). D'Arcy also prepared a two-dimensional diagram derived from multidimensional scaling, which shows that 'Switzerland and UK are very close' (page 343), but that Australia is far removed from the UK: 'the Australian system enforces its outsider position by certain requirements and prohibitions' (page 345).

Having arrived at this counter-intuitive result concerning Australia, d'Arcy does not question the data but accepts the result and seeks to explain it. Although d'Arcy uses superior methods, this reminds one of previous classifications based on data that had not been prepared for the purpose of classification. For example, it was noted above that Da Costa *et al*. (1978) attempt to justify, rather than question, why Germany was in the same group as the US but Canada was not, and why UK accounting was apparently less like US accounting than any other in the world.

3.8.2 New data, old problems

The OKPMG data are much more recent than those of PW. They cover fewer countries and are more reliable. Further, they do not mix rules and practices, but are clearly based on rules alone. However, this might itself be a problem. For example, IFRS allows certain intangible assets to be measured at fair value, whereas US GAAP requires the cost basis. Is that difference in rules relevant for classification if, in practice, no IFRS companies choose to use fair value?

There are other problems with the data. First, as with the PW data, the OKPMG data were not collected or designed for the purposes of classification. Therefore, important questions may be missing or may be swamped by less important ones. The second problem is that, unlike PW, the OKPMG data were not already in codeable form. D'Arcy (2001) uses careful methods to code them but, according to Nobes (2004), introduces a series of errors in the process. Nobes shows that adjusted data would not lead to a classification with Australia as an outlier and would probably produce an Anglo-Saxon group.

3.9 Is there an Anglo-Saxon group?

Classification can be affected by who is doing the classifying. For example, throughout recorded history (until and, in some cases, beyond the work of Charles Darwin), *homo sapiens* refused to believe that he was closely related to other apes, despite rather obvious similarities. For accounting classifications, most of the early writers had US or UK origins, so they were most familiar with US and UK accounting, and had noticed the differences. They then fitted the rest of the world around that starting point, often leading to a three-way classification: US, UK and Other. This explanation is consistent with classifications 1, 3 and 4 of Table 3.1: Hatfield (1966, based on a speech of 1911) and the similar ones of Seidler (1967) and of the American Accounting Association (AAA, 1977, page 105). These classifications were all drawn up by Americans. However, classification 2 was produced by Gerhard Mueller, whose initial education was in Germany. Thus, Mueller had a different view of the world, in which the US and the UK are together in one class, and the other three classes are each typified by a different continental European country. The influence of this

subjectivity is, of course, most likely when the classifiers do not collect data but use their general insights.

An extreme version of the above approach, of starting with the US and the UK, can be found in Shoenthal (1998) and in Alexander and Archer (2000). In these, the writers (all from North America or the UK) identify some differences between the United Kingdom and the United States (though these relate to the context of accounting rather than to accounting practices) and then conclude that the United Kingdom and the United States cannot be classified together. This would be like observing that two cousins exhibit many differences, and therefore cannot be closely related.

Cairns (1997) also cast doubt on the two-group classification of Figures 3.3 and 3.4. Cairns argues, for example, that:

> . . . the distinction between Anglo-American accounting and Continental European accounting is becoming less and less relevant and more and more confused.
>
> . . . there are now probably far more similarities between American and German accounting than there are between American and British accounting.

Nobes (1998b) suggested that the fact that some large German groups were using IFRS or US rules for consolidated statements did not directly affect the German accounting rules themselves. However, Nobes agreed that the distinction between the two groups was becoming less stark, partly because of some success by the EU and the IASC, particularly in harmonizing consolidated accounting. He nevertheless proposed that the two-group system still has descriptive power and recent empirical support (see Section 3.7.2 and below).

Alexander and Archer (2000) suggested that it is a myth that there is a coherent group of countries that was using Anglo-Saxon accounting. However, much of their discussion concerned not accounting practices but regulatory systems, which are indeed different in the United Kingdom and the United States (see Section 3.5.5). The introductory chapters of this book have argued that there is a clearly definable Anglo-Saxon grouping in terms of purposes and practices. Nobes (2003) suggests that the 'Anglo-Saxon' hypothesis helps to explain the international accounting developments of the last few years.

As noted above, d'Arcy (2001) did not find an Anglo-American cluster, perhaps due to imperfect data. There is another type of empirical support for the two-group classification. Guenther and Young (2000) find that accounting earnings in the United Kingdom and the United States are more closely related to underlying economic activity than are accounting earnings in France and Germany. Hung (2000) finds a difference between the two pairs of countries with respect to the usefulness of aspects of accrual accounting. Ali and Hwang (2000) also find that the link between share prices and financial reporting information is less for countries with bank-oriented rather than market-oriented financial systems.

3.10 Classification in an IFRS world

Although the gradual adoption of IFRS (or convergence with it) has reduced international differences, there is still a place for classification because:

- it can help to describe past international differences in accounting systems;
- for some or all purposes, many countries retain national accounting systems that are noticeably different from IFRS, and for these the old classifications may survive;
- previous classifications can predict or explain the internationally different degrees of convergence with IFRS;
- the reactions of countries concerning whether to require or allow IFRS for various purposes have differed greatly, and classification can help to predict or explain this.

Sellhorn and Gornik-Tomaszewski (2006) investigate this last point. They classify EU countries by their initial reactions to the 'IAS Regulation' of 2002, which requires IFRS for some purposes and allows it for others. They note that those with 'Class A' accounting tend to permit IFRS for unconsolidated statements. Similarly, Nobes (2008) divides the 27 countries that were EU members in 2006 into two classes using previous classifications. This is a strong predictor of whether a country still requires national rules for unconsolidated accounting. In terms of Figure 3.4, it is the 'weak equity' countries that still require national rules. Elad (2015) applies the logic of Nobes (2008) to African countries, producing a classification which shows that IFRS is adopted much more willingly in British-influenced countries than in Africa's franc zone countries.

However, there is yet a further point: national versions of IFRS practice exist, and these can be classified as a way of assisting with an understanding of this. There is scope for national versions of IFRS practice because, within IFRS, companies have a number of choices. The reasons for differences between national accounting systems can, to some extent, affect IFRS practices, as will be explained in Chapter 7. The resulting national profiles of IFRS practices have been classified by Nobes (2011), who examines the 2008/9 IFRS practices of large listed companies from eight of the countries in Figure 3.3. The result is that, after decades of harmonization (see Chapter 4), Australia and the UK are still in the same group, and continental European countries are in another group. Incidentally, this is the only classification in Table 3.1 that is based on the actual accounting practices of companies as observed from annual reports. Of course, as all the eight countries are using the same rules, there would be nothing to classify if differences in rules had been examined. This casts further doubt on the usefulness of many of the earlier classifications which were based on rules.

3.11 A synthesis of accounting classifications

In order to practice what we preach, we have prepared a classification of several of this chapter's accounting classifications. This is done in order to sharpen description and analysis, and to give order to a large number of facts. The classification in Figure 3.5 first divides the classifications into extrinsic and intrinsic on the basis of whether or not their direct subject matter is financial reporting practice or the content of the rules that control it.

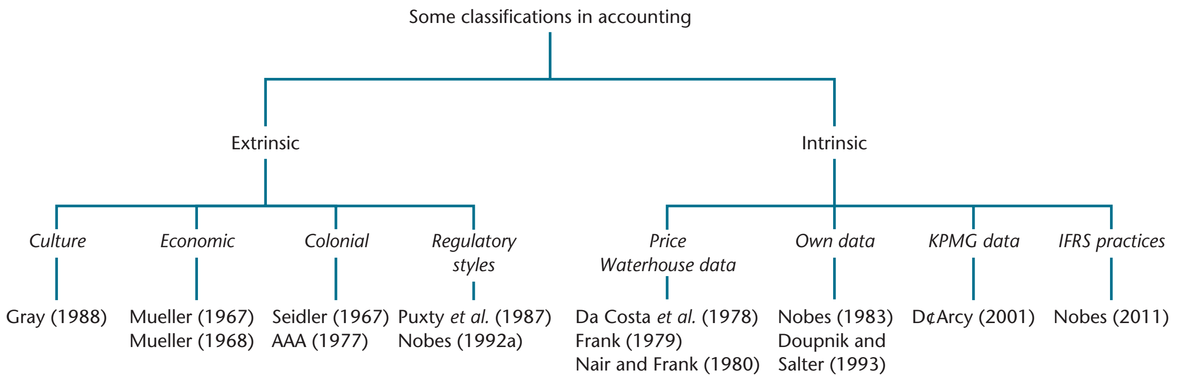

Figure 3.5 A taxonomy of some accounting classifications

The extrinsic studies are then grouped by their main topic: culture, economic and related environments, colonial spheres of influence, or regulatory style. The intrinsic studies are grouped by the source of data. It would also have been relevant to group by whether the data concerned rules or practices, but in several cases there is a mixture.

Nobes and Stadler (2013) provide a meta-analysis of all the classifications. That is, they see which countries tend to be put together by the classifiers. They find little consensus about the classification groups. For example, the results for Italy reveal that there is little agreement concerning which countries it should be classified with. However, there is strong consensus that Italy should *not* be classified with 'Anglo' countries. Similar remarks apply to France, Spain and Germany. Secondly, a British group can be identified, which includes Australia and Hong Kong. However, North America is not included in that group: only Canada has usually been classified with the United States.

Several caveats must be entered about this meta-analysis. First, it uses data (i.e. the classifications) spanning several decades, during which countries might have changed their relationships. This and other reasons might mean that the various results should not have been combined. Nevertheless, the extent that certain pairs of countries retain their relative positions over many decades (even surviving a move to IFRS) suggests that the classifications are picking up something fundamental. However, whether the insights from this analysis can be relied upon at all depends greatly on whether there are biased errors in the data or the methods used by the previous classifiers. This is a central issue, which has been mentioned several times above.

These observations prompted Nobes and Stadler (2013) to ask whether classifications can be relied on at all. To assess this, they collect data on IFRS practices, similar to that used in Nobes (2011), but for more countries and for 2011 annual reports rather than those of 2008. They then produced many classifications by variously omitting certain countries, industrial sectors or topics from their data. They found that the inclusion or exclusion of particular countries does not generally affect how the remaining countries fall into the two (or sometimes three) groups produced. However, in the more detailed classifications, the inclusion or exclusion of country X can cause country Y to change its position. So, this caveat should be noted by classifiers.

The key issue is the selection of characteristics to represent a country. For example, no overall 'Anglo' group was found when using all the data. However, by excluding presentation topics (which some researchers have claimed are less fundamental), Australia and Canada join an 'Anglo' group. By selecting different characteristics, quite different classifications emerge. This means that classifiers should not leave the selection of characteristics to the preparers of databases. The apparent objectivity of relying on someone else's subjectivity (e.g. by using the topics chosen by Price Waterhouse or KPMG for purposes other than classification) is greatly outweighed by the need to address the issue of which characteristics matter. The data also show stark differences between sectors in IFRS choices on certain topics. However, this does not generally affect the classifications.

Depending on the topics, countries and sectors included, a two-group classification of countries could be produced which corresponds exactly with a common/code law split. However, it would be possible to produce classifications from the same data which do not. Again, classifiers should discuss such sensitivity.

Despite the above findings, certain aspects of the classifications of Nobes and Stadler were remarkably stable, e.g. Italy and Spain were always in the same group, and never with the UK. Hong Kong companies and IFRS-using Chinese companies (which are listed in Hong Kong) are generally classified with the UK; and Switzerland is classified with Germany. Nobes and Stadler therefore concluded that the classifications based on IFRS choices were not essentially arbitrary, although they were particularly sensitive to the selection of topics.

Linnaeus (1751, section 156) stressed the centrality of classification, 'without which botany is chaos'. Classification of accounting systems can also be a useful device for organizing knowledge. However, as in other disciplines, it is fraught with difficulties and judgements. Given that researchers and others find the activity of classifying irresistible, at least the difficulties and judgements should be disclosed.

SUMMARY

- Classification is of fundamental importance to natural scientists, and has also been used in many social sciences. It seems reasonable that we might gain from a classification exercise in comparative international accounting, and that similar rules of classification to those used by scientists might be appropriate. In accounting, such classification may aid understanding and training, and may help to chart the need for, and progress of, harmonization.
- There have been many attempts at classification in international accounting, and there has been much description and data gathering. Mueller's four-group classification of influences and later classification of environments were useful preliminary works. However, the classifications would benefit from a hierarchy.
- Other attempts have been made to construct morphologies and to identify 'zones of influence' or the effects of culture.
- Other classification studies have used the Price Waterhouse survey data of 1973–1979. The results seem to vary in their plausibility, and there are doubts about the suitability of the data.

- A classification was also proposed by one of the authors. This had a hierarchy and has been tested in a number of ways. Classification studies have been continued in the 1980s and 1990s, benefiting from a number of critiques.
- A classification using the KPMG data of 1995 repeats some of the problems of those using the Price Waterhouse data.
- Some of the classification work is now of historical interest. However, international differences remain in the many countries that have not yet adopted or converged with IFRS for all accounting purposes. Classification can also predict or explain national reactions to IFRS.
- None of the above classifications are based on actual practices of companies. However, a classification of eight countries based on IFRS practices has now been made.
- A meta-analysis of the classifications shows only limited consensus about which countries should be shown together.
- A test of the sensitivity of classifications shows that they are fairly robust to changes in the countries and sectors included, but that they are highly dependent on the characteristics used for classification.

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

3.1* In what ways might classification be useful in any field of study? Use international differences in financial reporting as an illustration of your answer.

3.2* 'The essential problems of attempts to classify financial reporting practices across the world are related to the suitability of the data upon which such classifications have been based.' Comment.

3.3 To what extent is differing national culture relevant to an understanding of the causes of accounting differences, and therefore to the process of classification of countries?

3.4 How would you judge the relative success of attempts to provide classifications in comparative international accounting?

3.5 Which of the main models of international classification of accounting do you prefer? Explain your reasoning.

3.6 When producing classifications in the field of comparative international accounting, what should one be classifying?

3.7 Do the accounting classifications suggest that there is or was such a thing as Anglo-Saxon accounting?

3.8 To what extent have the accounting classifications become irrelevant because of international harmonization?

4 International harmonization

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OBJECTIVES

After reading this chapter, you should be able to:

- assess the arguments for and against international harmonization or standardization of financial reporting;
- illustrate how harmonization can be measured;
- outline the history, purpose and activities of the International Accounting Standards Committee (IASC);
- explain how the IASC had different effects in different types of country;
- summarize the relevance of other bodies for harmonization;
- explain the structure and workings of the International Accounting Standards Board.

4.1 Introduction

The preceding (and the following) chapters make it clear that there have been major differences in the financial reporting practices of companies around the world. This had led to great complications for those preparing, consolidating, auditing and interpreting published financial statements. As the preparation of internal financial information often overlaps with the preparation of published information, the complications spread to management accounting. To combat these difficulties, several organizations throughout the world have been involved in attempts to harmonize or standardize accounting. Market forces also contribute to this, as will become clear.

'Harmony' is a state where compatibility of accounting practice has been achieved. 'Harmonization' is a process of increasing the compatibility by setting bounds to their degree of variation. 'Standardization' appears to imply working towards a more rigid and narrow set of rules. However, within accounting, the words have almost become technical terms, and one cannot rely upon the normal differences in their meanings. 'Harmonization' is a word that tends to be associated with the transnational legislation emanating from the European Union; 'standardization' is often associated with the International Accounting Standards Board. From now on, we will generally use 'harmony' and 'harmonization' because they have the wider meaning. It is also important to distinguish between harmonization of rules (*de jure*) and harmonization of practices (*de facto*). Tay and Parker (1990) point out that *de facto* harmonization/standardization is more useful than *de jure* harmonization/standardization. 'Convergence' is a term that has come into use more recently, particularly in the context of narrowing the gap between IFRS and a set of national rules. This is taken further in Chapter 5. 'Uniformity' is where two or more sets of rules or practices are the same.

In principle, harmony can be achieved without uniformity, and vice versa. Let us take the example of inventory valuation, and the determination of cost according to FIFO (first in, first out) or LIFO (last in, first out). If two sets of rules require FIFO only, then they are *de jure* uniform. This will lead to uniform practice if the rules are properly obeyed. If the two sets of rules are identical and both allow FIFO and LIFO, they might be said to be uniform, but uniform practice need not result. However, if the rules require that any user of LIFO must disclose FIFO information in the notes,

full *de facto* harmony might be achieved without full *de facto* uniformity, because the users of different financial statements can all come to a comparable conclusion about inventory values using the available FIFO information.

De jure harmony is possible without *de facto* harmony, if companies do not comply with rules. By contrast, *de facto* harmony can be achieved without *de jure* harmony when market forces persuade many companies, for example in Switzerland and Japan, to produce English-language financial reports that follow IASB rules.

This chapter now looks at the purposes of and obstacles to harmonization. Section 4.3 examines the nature and the work of the IASC, which operated from 1973 to 2001. Some other bodies with an interest in harmonization are looked at briefly in Section 4.4, followed by a close look at the IASC's successor, the IASB. The IASB's standards and the resulting practices are analyzed in Chapters 6 and 7. More detail on the EU's harmonization process is found in Chapter 13. Baker and Barbu (2007) survey the academic literature on harmonization from 1965 to 2004 and note a great increase in volume and sophistication of the literature over the period.

4.2 Reasons for, obstacles to and measurement of harmonization

4.2.1 Reasons for harmonization

Financial reports produced in one country are used in various other countries. Consequently, the reasons that make national accounting standards desirable also apply internationally. Standardization can reduce administrative costs, improve the quality of accounting and increase comparability. The pressure for international harmonization comes from those who use, regulate and prepare financial statements.

Investors and financial analysts need to be able to understand the financial statements of foreign companies whose shares they might wish to buy. They would like to be sure that statements from different countries are reliable and comparable, or at least to be clear about the nature and magnitude of the differences. They also need confidence in the soundness of the auditing.

For this reason, various intergovernmental transnational bodies are interested, among other things, in protecting investors within their spheres of influence. Also, in cases where foreign shares are quoted on a stock exchange, that stock exchange or its regulator may demand financial statements that are consistent with domestic practices or IFRS. In addition, those companies that wish to issue new shares more widely than on their domestic markets will see the advantages of harmonized practices in the promotion of their issues. International credit grantors such as the World Bank also face the difficulties of international comparison.

These pressures will also be felt by companies that do not operate multinationally. However, for multinationals, the advantages of harmonization are much more important. The great effort of financial accountants to prepare and consolidate financial statements is much simplified if statements from all round the world are prepared on the same basis. Similarly, the task of preparing comparable internal information for the appraisal of the performance of subsidiaries in different countries is made

much easier. Many aspects of investment appraisal, performance evaluation and other decision-making uses of management accounting information benefit from harmonization. The appraisal of foreign companies for potential takeovers is also greatly facilitated. Multinational companies also find it easier to transfer accounting staff from one country to another. Above all, if accounting can be made more comparable and reliable, the cost of capital should be brought down by reducing the risk for investors.

A third group involved in harmonization are the international accountancy firms. They support harmonization partly because it is good for their large clients. Also, the tax authorities throughout the world have their work greatly complicated, when assessing foreign incomes, by differences in the measurement of profit in different countries. It should be admitted, however, that tax authorities have caused many of the differences, for example the influence of tax on continental European accounting (see Chapter 15) and the use of LIFO in the United States (see Chapter 8). Governments in developing countries might find it easier to understand and control the operations of multinationals if financial reporting were more uniform, particularly as this would imply greater disclosure in some cases. Other organizations that would benefit from greater international comparability of company information are labour unions that face multinational employers. All these groups might benefit from harmonization.

4.2.2 Example of the need for harmonization

Much of this book is devoted to the analysis of international differences in financial reporting. The number and magnitude of the differences make clear the scope for harmonization. For example, on something as basic as inventory valuation, practices in major countries include:

- cost (FIFO, LIFO or weighted average) (e.g. some Japanese companies until 2007);
- the lower of FIFO and net realizable value (e.g. common IFRS practice);
- the lower of LIFO and current replacement cost (e.g. common US practice).

Adding all the differences together, the effects on earnings or shareholders' equity can be very large, as illustrated at the beginning of Chapter 1.

4.2.3 Obstacles to harmonization

The most fundamental of obstacles to achieving uniform practice was the size of the present differences between the accounting practices of different countries. Using the type of classifications of accounting systems discussed in Chapter 3, there are several significant differences even within the 'strong equity' class, let alone between that class and the other. These differences go to the root of the reasons for the preparation of accounting information. The general dichotomy between investor/fair accounting and creditor/tax/conservative accounting is an obstacle that cannot be overcome without major changes in attitudes and law.

Indeed, it is not clear that it should be overcome. If the predominant purposes of financial reporting vary by country, it seems reasonable that the reporting should vary. Harmonization is most useful when it concerns similar users who receive

information from companies in different countries. It may be that the relevant companies should follow two sets of rules: one for domestic and another for international consumption, or one for individual entity statements and another for consolidated. This is discussed further at the end of Section 4.3.

Another obstacle is the lack of an international regulatory agency. The European Union is such an agency for one part of the world; and the International Organization of Securities Commissions (IOSCO) has influence for listed companies. These bodies are discussed in Section 4.4.

A further problem is nationalism. This may show itself in an unwillingness to accept compromises that involve changing accounting practices towards those of other countries. This unwillingness may exist on the part of accountants and companies or on the part of states that may not wish to lose their sovereignty. Another manifestation of nationalism may be the lack of knowledge of or interest in accounting elsewhere.

Another difficulty is the effect of 'economic consequences' on accounting standards (for example, see Chapters 5, 10 and 17). To the extent that economic consequences of standards vary by country and to the extent that they are taken into account by those who set standards, this could be a force that opposes harmonization.

4.2.4 Measurement of harmonization

Statistical methods for the measurement of de facto harmony and harmonization were first developed by van der Tas (1988, 1992). He suggested: an H (Herfindahl) index of national harmony; an I index (including a correction factor) of international harmony; and a C or comparability index. Archer *et al.* (1995) decomposed van der Tas's C index into a between-country C index and a within-country C index, and argued that the latter was superior to the corrected I index. Further discussion of the statistical properties and uses of these indices can be found in Herrmann and Thomas (1995), Archer *et al.* (1996), Krisement (1997) and Morris and Parker (1998). Other researchers making use of these indices include Emenyonu and Gray (1992, 1996). Rahman *et al.* (1996) suggested ways in which de jure harmonization can be measured.

Cañibano and Mora (2000) studied de facto harmonization in Europe between 1991/2 and 1996/7. They applied a significance test to the C index and find harmonization in the period. They attribute this not to regulatory changes but to the desire of very large companies ('global players') to compete for capital in the international markets. Aisbitt (2001) examined the usefulness of the C index and used harmonization in the Nordic region between 1981 and 1998 as a case study. She pointed out a series of problems, suggesting that qualitative study may be better than progressively more complex statistics.

Pierce and Weetman (2002) built on Archer *et al.* (1995) and Morris and Parker (1998) to develop a generalized formula for the between-country C index in which non-disclosure is split into cases where disclosure would be applicable and those where it would not be. They apply their methods to the harmonization of deferred tax accounting in Denmark and Ireland between 1986 and 1993. Taplin (2003) noted that previous researchers do not provide a calculation of the standard error of an index so as to give guidance on the likely values of the index in the population from

which a sample was drawn. He suggested formulae for the calculation of standard errors. Taplin (2004) examined previously used indices and suggested a way of choosing the most appropriate one, for any particular piece of research, based on four criteria. Taplin (2011) proposed further improvements to the indices of harmony.

Baker and Barbu (2007, pp. 289–91) reviewed the literature on the measurement of harmonization. Jaafar and McLeay (2007) warned that, although country effects are by far the best single explanation of accounting differences between companies, some variation is caused by a company's sector, its size or how many exchanges it is listed on. Therefore, some accounting differences between companies might be caused by real economic differences in the sort of transactions that are typically done in different sectors. If a country has many companies in one particular sector, that would then affect the country's profile of accounting practices. This would not show a lack of harmony between countries but a justifiable difference between sectors.

4.3 The International Accounting Standards Committee

4.3.1 History and purpose of the IASC

Arguably, the most successful bodies involved in harmonization have been the IASC and its successor, the IASB. These two bodies and some others are looked at in this and the following sections.

The IASC was founded in 1973 by the accountancy bodies of nine countries: Australia, Canada, France, Japan, Mexico, the Netherlands, the United Kingdom with Ireland, the United States and West Germany (Benson, 1979). A predecessor body, set up in 1966, was the Accountants' International Study Group (AISG) at which the professional bodies of Canada, the United Kingdom and the United States examined their differences in accounting practices. Also relevant were the World Congresses of Accountants (see Section 4.4). The preliminary discussions towards setting up the IASC were held at meetings arranged in the margins of the Congress in Sydney in 1972. Another background factor was that the UK joined the Common Market (later EU) in 1973. Both the UK and the US professions were concerned about the draft Fourth Directive, which contained unattractive accounting rules for UK companies and for the European subsidiaries of multinationals (Olson, 1982, page 226). The IASC can be seen as a countervailing force.

Mason (1978) had suggested that there were six 'vital countries' to involve in harmonization: France, Germany, Japan, the Netherlands, the United Kingdom and the United States. All these countries were among the IASC's founding members. Mason chose them partly on the grounds of the strengths of their accountancy professions and standard-setting experience. Some readers might be surprised by the inclusion of the Netherlands, but it had a long history of innovative accounting and the world's oldest stock market. It had also hosted the second World Congress of Accountants (see Section 4.4).

The IASC operated until early 2001, when it was succeeded by the International Accounting Standards Committee Foundation (IASCF), whose operating arm is the IASB. It is convenient to split our consideration of the IASC/B into two parts, with a break in 2001. Section 4.5 considers 2001 onwards.

Table 4.1 Board members of IASC (at 31 March 2001)

Australia	The Netherlands
Canada	Nordic Federation of Accountants
France	South Africa (with Zimbabwe)
Germany	United Kingdom
India (with Sri Lanka)	United States
Japan	Federation of Swiss Industrial Holding Companies
Malaysia	International Council of Investment Associations
Mexico	International Association of Financial Executives Institutes

The IASC was independent from all other bodies, but from 1983 a close connection was established with the International Federation of Accountants (IFAC), which will be discussed later. The membership of the IFAC and the IASC was identical, with over 150 accountancy bodies from over 110 countries by 2001. The IFAC concentrates on such matters as auditing, management accounting and the World Congresses of Accountants. The IASC was concerned only with international accounting standards. Its aim was 'to formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance' (IASC, 1992).

From 1983 to 2001, the IASC's Constitution provided for it to be run by a board of up to 17 members: 9 or 10 from developed countries, three or four from developing countries and up to four other organizations, generally drawn from the IASC's consultative group (which included such bodies as the World Bank, the International Confederation of Trades Unions and the International Federation of Stock Exchanges). The members at 31 March 2001, after which the IASC was replaced by the IASB, are shown in Table 4.1. There were never more than 16 members. Each was represented on the board by a delegation of two or three part-time people, with one vote per delegation. Kirsch (2006, Appendix IV) provides lists of members and representatives.

Board members of the IASC contributed much of its budget. The remaining members of the IFAC/IASC paid their subscriptions to the IFAC, which then funded another element of the IASC budget. Publication revenue and donations were also important.

The most authoritative and detailed source of information on the history of the IASC is Camfferman and Zeff (2007). Kirsch (2006) also provides much useful information.

4.3.2 The standards and acceptance of them

A list of the standards of the IASC is shown as Table 4.2. The IASB adopted these standards en bloc in 2001, but made major amendments and additions from 2003. A list after those amendments is shown in Chapter 6, where the standards themselves are examined. Standards were preceded by exposure drafts. In order to be published, an exposure draft had to be approved by a two-thirds majority of the IASC's board; a subsequent standard by a three-quarters majority. In 1989, the IASC published a conceptual framework, which is somewhat similar to that of the FASB (see Chapter 8).

Table 4.2 IASC standards (early 2016)

IAS	Topic*
1	Presentation of financial statements
2	Inventories
[3]	Consolidated financial statements (superseded by IAS 27 and IAS 28)
[4]	Depreciation accounting (withdrawn in 1999)
[5]	Information to be disclosed in financial statements (superseded by revised IAS 1)
[6]	Accounting responses to changing prices (superseded by IAS 15)
7	Statement of cash flows
8	Accounting policies, changes in accounting estimates and errors
[9]	Research and development costs (superseded by IAS 38)
10	Events after the reporting period
[11]	Construction contracts (superseded by IFRS 15)
12	Income taxes
[13]	Presentation of current assets and current liabilities (superseded by revised IAS 1)
[14]	Segment reporting (superseded by IFRS 8)
[15]	Information reflecting the effects of changing prices (withdrawn in 2003)
16	Property, plant and equipment
[17]	Leases (superseded by IFRS 16)
[18]	Revenue (superseded by IFRS 15)
19	Employee benefits
20	Accounting for government grants and disclosure of government assistance
21	The effects of changes in foreign exchange rates
[22]	Business combinations (superseded by IFRS 3)
23	Borrowing costs
24	Related party disclosures
[25]	Accounting for investments (superseded by IAS 39 and IAS 40)
26	Accounting and reporting by retirement benefit plans
27	Separate financial statements
28	Investments in associates and joint ventures
29	Financial reporting in hyperinflationary economies
[30]	Disclosures in the financial statements of banks and similar financial institutions (superseded by IFRS 7)
[31]	Interests in joint ventures (superseded by IFRS 11)
32	Financial instruments: presentation
33	Earnings per share
34	Interim financial reporting
[35]	Discontinuing operations (superseded by IFRS 5)
36	Impairment of assets
37	Provisions, contingent liabilities and contingent assets
38	Intangible assets
[39]	Financial instruments: recognition and measurement (superseded by IFRS 9)
40	Investment property
41	Agriculture

Note: Square brackets denote standards now superseded or withdrawn.
*The titles here are taken from the latest versions, or those current when the Standard was withdrawn.

There are also strong similarities with the later Australian and British frameworks. The framework was also adopted by the IASB and is used when preparing standards. As will be explained in Chapter 6, the IASB has amended the framework from time to time.

Countries influenced by the Anglo-American tradition are most familiar with setting accounting rules in this way, and are most likely to be able to adopt non-governmental rules. It is not surprising, then, that the working language of the IASC was English, that its secretariat was in London and that most standards closely followed, or compromised between, US and UK standards, as Table 4.3 shows. However, the degree to which the United States and the United Kingdom dominated the IASC was a matter of fierce debate (see, for example, Cairns, 1997; Flower, 1997; Flower, 1998; Nobes, 1998; Alexander and Archer, 2000; Nobes, 2003).

Table 4.3 Some international standards compared to US and UK rules (pre-1993 to 2015)

Topic	US	UK	IAS (before 1993 revisions, effective 1995)	IAS/IFRS (revised)
Inventories (IAS 2)	LIFO allowed, with disclosure of FIFO	LIFO not allowed	LIFO allowed	From 1995 to 2004: LIFO allowed, with disclosure of FIFO. From 2005: LIFO not allowed
R&D (IAS 9; IAS 38)	All expensed (except some software costs)	Research expensed; certain development can be capitalized	Research expensed; certain development can be capitalized	From 1995: research expensed; certain development must be capitalized
Goodwill (IAS 22; IFRS 3)	To 2001: amortized over up to 40 years. From 2001: not amortized but tested annually for impairment From 2011: can avoid impairment calculation if assessment suggests not necessary	To 1998: amortized over useful life; or (normally) written off against reserves immediately. From 1998: amortized over up to 20 years (rebuttable presumption)	Amortized over useful life; or written off against reserves immediately	From 1995 to 1998: amortized over up to 20 years. From 1999 to 2004: amortized over up to 20 years (rebuttable presumption). From 2005: tested annually for impairment
Deferred Tax (IAS 12)	From 1992: full allocation; liability method; balance sheet basis.	Liability method; profit and loss basis. To 2001: partial allocation. From 2001: full allocation	Partial or full allocation; deferral or liability method; profit and loss basis	From 1998: as United States

By the late 1980s it had become clear that the substantial number of options in IASs were an obstacle to further enhancement of the status of the IASC's work. In particular, IOSCO, a committee of governmental regulatory bodies, held out the possibility that its members (e.g. the SEC) might accept IASs for the financial reporting of foreign companies listed on their stock exchanges. However, IOSCO made it clear that a reduction in options was essential. This was one of the spurs to the issue of the exposure draft, E 32, which launched the improvements/comparability project in 1989 (Purvis *et al.*, 1991).

After several years of detailed argument over the removal of options, 10 revised standards were agreed in November 1993 to come into force in 1995. Table 4.3 gives some examples of the effects. In the case of IAS 2, although E 32 proposed to remove the LIFO option, it was not possible to obtain the necessary 75 per cent majority (i.e., at that time, 11 out of 14 board member votes). In the case of IAS 9 and IAS 22, options were removed. Furthermore, these IASs required practices that were inconsistent with US or UK practices, namely:

- IAS 9 (of 1993; absorbed into IAS 38 of 1998) *requires* suitable development costs to be recognized as assets. This is in conflict with US rules (which do not allow such capitalization, except for software costs) and inconsistent with majority UK practice (SSAP 13 merely *allowed* capitalization). Incidentally, it was also in conflict with practice in such countries as France, Spain or Japan, where R&D costs were usually not capitalized but where *both* could be.
- IAS 22 (of 1993) required goodwill to be capitalized and amortized over its useful life, which should not have exceeded five years unless a longer period (up to 20 years) could be justified. This was inconsistent with the then US rules (amortize over up to 40 years) and UK practice (generally to write off goodwill against reserves). Subsequently, as Table 4.3 records, both UK and IAS rules changed to be approximately in line with each other, until further US change led to further IAS change.

IAS 12 was not part of the E 32 project, but a revision in force from 1998 led to the UK and several other countries being out of line with the IAS on deferred tax.

The response of IOSCO to the revisions of 1993 was to welcome them but to call for further revisions and new IASs so that a set of 'core standards' could be accepted for the financial reporting of companies with cross-border listings. In 1995, IOSCO and IASC agreed a detailed plan to achieve this, scheduled for completion in 1998 or 1999. In the meantime, IOSCO accepted IAS 7 for cash flow reporting; and the SEC went beyond that for its foreign registrants by also accepting elements of other IASs. The IASC finished the core programme with IASs 39 and 40, published in 1999 and 2000.

The IASs that were issued or revised from 1993 onwards (see examples in Table 4.3) contained fewer options than previous standards, although resistance to the introduction of fair value (and to taking unsettled gains) led to major options (and other opportunities) to continue to use cost in IASs 39, 40 and 41 (see Chapter 6).

A relevant development of 1996 was the IASC's decision to set up a Standing Interpretations Committee (SIC) which set out the IASC's view on certain issues that were not dealt with in sufficient detail or clarity by IASs. The work of the SIC further tightened up the IASC's requirements. The SIC was replaced by the International Financial

Reporting Interpretations Committee (IFRIC), now re-named the IFRS Interpretations Committee.

In 2000, IOSCO recommended IASs to its members. As a result, international standards were accepted for financial reporting on most exchanges, although not initially in the USA (see Section 4.5.3). Also in 2000, the Commission of the EU announced a new plan to strengthen its capital markets. This included a proposal for the use of international standards by listed companies (see Section 5.2). Consequently, by the end of the IASC's life, international standards were achieving the official backing that had been sought for decades.

4.3.3 Was the IASC successful?

In order to determine whether the IASC was successful it is necessary to establish the criteria by which success should be measured. We might start by looking at the stated objectives of the IASC, though we need to confirm that these are reasonable and useful objectives before adopting them as the measure for the IASC's success. The IASC's basic objective was to publish and promote the acceptance of standards on a worldwide basis. This objective might once have been thought to be too ambitious in one respect and not ambitious enough in another.

Until fairly recently, to attempt worldwide standardization seemed a hopeless and unnecessary target. The greatest benefits come from standardization among countries where there are companies that publish financial statements and that have foreign investors, auditors, parents or subsidiaries. This means that the context of success might more sensibly have been seen as the developed non-communist world and those developing countries with which it had significant economic links. Until the 1990s, to try to bring the accounting of the Soviet Union or China into line, for example, not only would have had very few benefits but also would have been impossible. However, the IASC became an important influence on Russia and China when their communist economic systems were dismantled, and so the description 'worldwide' is now appropriate, as examined later.

Secondly, to publish and promote standards is not a sufficient aim. Fortunately, in the IASC's 1983 Preface and Constitution, the more fundamental aim of standardizing accounting *practices* was recognized. What is needed is progress towards an easier and surer comparability of published financial statements from different countries, or at least disclosure of the nature and significance of the differences.

The IASC can now be judged against the two objectives. In terms of issuing standards, there was clearly success. Forty-one standards (many of them with subsequent amendments by the IASC) were issued, along with a conceptual framework and other publications. Although the standards were criticized for allowing many options, this feature was probably essential to allow early progress, and it was seriously addressed in the early 1990s onwards (see Section 4.3.2).

The objectives of promotion and observance of standards and of general harmonization are more complex, particularly because the IASC had no authority of its own to impose its standards on companies. Success in this area up to 2001 will now be examined for four types of country: developing countries, emerging nations, continental Western Europe and Japan, and capital-market countries. The position from 2001 is looked at in Section 4.5.

Developing countries

It is perhaps in developing and newly industrialized countries that the clearest and most spectacular success for the IASC might be claimed during the 1990s. Many countries (e.g. Nigeria, Malaysia and Singapore) adopted IASs with few or no amendments as their national standards.

IASs were of importance also to many other developing countries, particularly those with a British legacy, which rely on private-sector standard-setting. These countries were members of the IASC, and some of them had been members of the board, or of working parties on particular standards. The adoption of IASs was a cheaper route for these countries than preparing their own standards and has the great advantage of making life easier for those domestic or foreign companies or accountants with international connections. The other advantage is avoidance of the politically unattractive alternative (for some countries) of adoption of US or UK standards. This use of IASs is of great value to these many countries and serves the interests of international harmonization by avoiding the creation of different rules. However, there are some doubts about the suitability of the standards for developing countries (Briston, 1978). For example, the complication of the standards and the extensive disclosures that they require might involve costs that exceed the benefits for a country with few listed companies.

Nevertheless, Saudagaran and Diga (2003) conclude, using ASEAN countries as an example, that harmonization will continue and will be based on IASB's standards. Zeghal and Mhedhbi (2006) suggest that the most likely countries to adopt international standards are those with capital markets and Anglo-American culture.

Emerging nations

Somewhat similar remarks as for developing countries may be made about those nations that moved from communist to capitalist economics, such as China and Eastern Europe. They needed a 'quick fix' to their accounting practices as they changed at breakneck speed from economies with no 'profit', no shareholders, no independent auditors and no stock markets. To some extent, institutions from the West competed to influence these countries (e.g. UK accountancy bodies, the French government, German banks and the EU). However, the IASC as a worldwide standard-setter had advantages that enabled it to be a key influence. Further comments on this are found in Chapters 5, 11 and 13.

Continental Western Europe and Japan

Of the four types of country proposed here, it was in continental Europe and Japan that there was the greatest ambivalence towards the IASC. To some extent the IASC was seen as a Trojan horse concealing the Anglo-Saxon accounting enemy inside a more respectable international façade (Kleekämper, 2000). The horse was wheeled into the heart of Europe and then its contents subtly contributed to the undermining of traditional continental accounting. This was perhaps the view until the late 1990s of the German or Italian accounting establishment and of elements of the European Commission.

Certainly, in 1973, the standard-setting philosophy and the dominant idea of serving capital markets with 'fair' information was largely alien to continental Europe or

Japan. Nevertheless, the IASC moved forward with considerable support from these countries and remarkably little acrimony. The factors that helped this were:

- the large representation of non-Anglo-Saxon countries on the board and working parties, and the eventual appointment of a Frenchman and then a Japanese as chairperson of the IASC;
- national delegates from these countries who had been trained in large accountancy firms or multinationals and who were not governmental bureaucrats;
- the desire in several board-member countries to strengthen their capital markets and modernize their accounting (particularly strongly felt in France and Italy from the 1970s onwards);
- the increasing internationalization of the financial world, such that even some German and Japanese companies started to raise finance overseas;
- a desire to avoid US dominance of accounting, so that the IASC seemed the less bad alternative.

In many cases IASs were passed that were inconsistent with the letter or the spirit of some continental or Japanese rules. National delegates often voted against their own country's practices, and sometimes their country's practices subsequently changed towards the IAS. This latter feature was particularly obvious in the case of group accounting, where the EU Seventh Directive (see Chapter 16) caused dramatic changes in Europe, broadly in line with the contents of IASs. Also, the capitalization of leases and accounting for deferred tax began to seep into continental Europe.

Indirect effects can be seen in the gradual acceptance of many IASC ideas in continental Europe and Japan. For example, during the governmental negotiations on the Seventh Directive, the existence of IAS 3 on group accounting was a point of reference, particularly as it had been passed by a board containing so many EU members. Also, over the years, the representatives from the major countries have been engaged in continual debate at the IASC and other international bodies. This all contributed to understanding and an eventual softening of views.

The direct effects of the IASC on all of this were observable in two ways in the 1990s.

1 In some cases, rule-making authorities approved the use of IASs in certain circumstances, e.g. in France or Italy for certain aspects of consolidated accounts. The Japanese regulators began a process of examining conformity of their rules with IASs.
2 Some companies chose to use IASs in part or in whole for their main or supplementary financial statements. This was seen particularly in Switzerland and, from 1994, in Germany, but it applied to several large companies throughout continental Europe.

Governments responded to this desire by large European groups to use IAS or US accounting practices. In 1998, a German law was passed allowing listed companies to use 'internationally recognized' rules for their consolidated statements in place of the national rules. There were a few conditions, for example the rules had to be in accordance with the EU Directives. Until 2001, when IAS 39 came into force (see Table 4.2 and Chapter 6), this condition seemed to create no difficulties for the use of IASs. The Directives were amended in 2001 to ensure continued compatibility (see Chapter 13). However, there seemed to be some doubt that US rules met the condition.

As a result of the 1998 law, around one-third of the top 100 German groups were using IASs for their consolidated statements by 1999. Similar laws were passed in several other countries. For example, Austria passed such a law and extended the scope to all companies, not just listed ones. In France and Italy, laws similar to the German one were passed but not put into operation.

The response of the EU to all this was the dramatic proposal to require international standards for some purposes, as explained in Chapters 5 and 13.

Capital-market countries

The last group of countries includes former board members such as the United States, Canada, the United Kingdom, Australia, South Africa and the Netherlands. Increasingly, however, other Board countries joined this capital-market club, especially in relation to large companies or consolidated statements (notably France and the Nordic Federation).

Clearly, the publication of frequent, fair, consolidated, audited information for capital markets, using non-governmental standards set with the aid of a conceptual framework, is an idea associated with these countries. The content of IASs (certainly up to the improvements project) was closely consistent with practices in such countries. It seems, then, that they influenced the IASC, rather than the other way round. Indeed, until the late 1990s, US or UK standard-setters did not make major efforts to change their rules in those cases where there was inconsistency with IASs.

Nevertheless, IASC influence on standard-setters could be discerned. For example, in the United Kingdom, the conceptual framework of the Accounting Standards Board was prepared after the IASC's and is very close to it. Certainly, the standard-setters in the United Kingdom, Canada or Australia looked closely at the relevant IASC standards before setting or changing their own, and they were more comfortable when they are in conformity with the IASC. Several joint projects between these countries and the IASC were carried out in the late 1990s (e.g. IAS 14 revised, and IASs 33 and 37). By the late 1990s, the Australian standard-setter had begun to conform its standards with IASC (see Chapter 5).

At the level of companies in these countries, little direct effect of the IASC could be discerned until 2005, mainly because all companies were required to use domestic rules.

Support from 2000

As explained above, major evidence of IASC success appeared in 2000. First, IOSCO recommended IASs for acceptance by its members. Then the EU Commission proposed that IASs should become compulsory for the consolidated statements of all EU listed companies by 2005 (see Chapter 5). These moves should be seen in the context of the reform of the IASC (see Section 4.5) which was settled by then.

Martinez-Diaz (2005) traces the rise of the IASC from being an obscure body with little influence to becoming the global standard-setter. He identifies four factors:

1 Building of legitimacy through technical expertise.
2 Embedding itself in a network of international organizations.
3 Benefitting from rivalries among developed and developing nations, and among US and European regulators.
4 Having core values aligned with those of the SEC.

4.3.4 Empirical findings on the IASC

Section 4.2.4 discusses the measurement of harmonization. This section looks in particular at papers that try to examine the effects of the IASC.

There was some empirical analysis of the effects of the IASC. McKinnon and Jannell (1984), on de jure harmonization, concluded that 'the IASC has not succeeded in changing existing standards or setting new standards'. Evans and Taylor (1982) examined compliance with IAS standards for five of the six 'vital' countries. They suggested that the IASC had had little influence. Nair and Frank (1981) looked more widely at the degree of harmonization over the period 1973 to 1979. They arrived at no stronger a conclusion than that 'the period of the IASC's existence has coincided with a growing harmonization of accounting standards'.

Doupnik and Taylor (1985) found some increased compliance by nations with IASC standards, but their findings were disputed by Nobes (1987). Other empirical work includes that by Emenyonu and Gray (1996). Critiques of the IASC's work include those by Rivera (1989), Wallace (1990) and Goeltz (1991). However, all this research looked at practice before the improvements that came into force from 1995 onwards.

Weetman *et al.* (1998) suggested that there was increasing disharmony between UK accounting and IASC or US accounting. However, although they took account of *de jure* developments after 1995, they too studied the practices before that date. A survey of the conformity with IASs of the national rules in 62 countries for 31 December 2001 year ends showed a very large number of differences in nearly all the countries (Nobes, 2001). For example, there were many differences of detail for the UK and the US; many inconsistencies for several continental European countries; and many gaps in the rules of several developing and emerging countries.

Ali (2005) provides a summary of the empirical research on harmonization. Baker and Barbu (2007) provide a wider summary of research on international harmonization. The degree to which companies actually complied with IASs when they claimed to do so is discussed in Section 20.4.

4.4 Other international bodies

This section looks at the nature and importance of some other bodies that were concerned, from the 1970s onwards, with international aspects of accounting.

4.4.1 International Federation of Accountants (IFAC)

This body came into being in 1977 after the Eleventh World Congress of Accountants. It aims to develop a coordinated international accountancy profession. A predecessor body, called the International Coordination Committee for the Accountancy Profession (ICCAP), which had been formed in 1972 after the Tenth Congress, was wound up in favour of the IFAC.

The IFAC represents over 150 member accountancy bodies from around the world. It has a full-time secretariat in New York. Its work includes the setting of international

Table 4.4 World congresses of accountants

1904	St. Louis	1962	New York	1997	Paris
1926	Amsterdam	1967	Paris	2002	Hong Kong
1929	New York	1972	Sydney	2006	Istanbul
1933	London	1977	Munich	2010	Kuala Lumpur
1937	Berlin	1982	Mexico City	2014	Rome
1952	London	1987	Tokyo		
1957	Amsterdam	1992	Washington		

standards for auditing (via the International Auditing and Assurance Standards Board), ethics, education and management accounting; involvement in education and technical research; and organizing a world congress every four or five years. Table 4.4 lists the congresses, from the first one in 1904. Lemarchand *et al.* (2008) review the history of the congresses listed in Table 4.4 and also other international congresses (mainly French-speaking) not listed there.

Loft *et al.* (2006) examine the changing structure and growing importance of IFAC. They suggest that IFAC is now influenced more by experts and multinational audit firms than by national accountancy bodies.

4.4.2 The AISG, the G4+1 and the national standard-setters

As well as the ICCAP, another body was wound up in 1977 when the IFAC was formed – the Accountants' International Study Group. As mentioned earlier, this group had been formed in 1966 and comprised members from professional bodies in Canada, the United Kingdom and the United States. Its purpose was to study and report on accounting practices in the three countries. Twenty studies were issued, mainly on financial reporting matters.

By the early 1990s, a need for something similar was again perceived. By then, standard-setting in some of the Anglo-Saxon countries (e.g. the US and the UK, but not Canada and New Zealand) had been transferred from professional bodies to independent private-sector committees. The G4+1 group comprised the standard-setters of Australia, Canada, the UK and the US, with the IASC secretariat as observer (hence the '+1'). Later, the New Zealand standard-setter joined.

From 1995 onwards, the G4+1 issued a number of discussion papers, on such subjects as lease accounting and the measurement of performance. The members of the G4+1 shared similar conceptual frameworks and felt able to go further and faster than the Board of the IASC. This process helped to coordinate the efforts of these standard-setters.

In February 2001, after the new IASB had been appointed, the G4+1 was wound up. The discussion in Section 4.5 will reveal why the G4+1 was no longer necessary, given that so many former members of Anglo-Saxon standard-setters became IASB members. Street (2005) describes the work of the G4+1 and suggests that it had a major impact on the IASC and the IASB. Nobes (2006) suggests that Street exaggerates somewhat.

In 2005, a group of the world's major national standard-setters (NSS) began to meet to discuss IASB projects and to undertake research on major forthcoming issues. It was chaired by the Chairman of the UK's Accounting Standards Board until 2011, and then by the equivalent Canadian. The NSS now meets twice a year. In 2014, the group was re-named 'The International Forum of Accounting Standard-setters'. At the 2014 meeting, for example, representatives from 31 NSS attended, along with representatives from the IASB and regional groups. The Forum should not be confused with the 'world standard-setters' which is used by the IASB to disseminate information to a very wide group of countries. Nor should it be confused with the 'Accounting Standards Advisory Forum' which is an official body of the IFRS Foundation (see 4.5.1).

4.4.3 International Organization of Securities Commissions

IOSCO was founded in 1983. It is an association of governmental securities regulators, such as the Securities and Exchange Commission of the United States. Such regulators decide whether foreign or 'international' accounting standards are acceptable for the financial reporting of domestic or foreign listed companies.

In the late 1980s, IOSCO and the IASC reached an agreement whereby IASC would improve its standards and IOSCO would consider recommending them to all their exchanges. IASC's work of the 1990s was mostly designed to satisfy IOSCO, which also joined the IASC Board meetings as an official observer.

In 2000, IOSCO endorsed the IASC's standards, particularly for use by foreign registrants. Many regulators do accept international standards for foreign companies even if domestic standards are required for domestic companies. In 2007, the SEC accepted international standards for this purpose.

IOSCO and the SEC were important contributors to the discussions that led to the creation of the IASB in 2001 (see Section 4.5).

A body that coordinates the European members of IOSCO was founded in 2001 and called CESR (the Committee of European Securities Regulators). In 2011, CESR was replaced by the European Securities Markets Authority (ESMA). It has been active in promoting agencies which monitor and enforce the use of IFRS by listed companies in Europe (see Chapter 20).

4.4.4 European Union

The European Union is discussed at greater length later: in Section 5.2 concerning its requirement to use IFRS for the consolidated statements of listed companies from 2005, and in Chapter 13 concerning its efforts for the harmonization of national accounting rules in Europe since the 1970s. In both capacities the EU has been a major player in the harmonization of accounting.

4.4.5 Fédération des Experts Comptables Européens and the European Financial Reporting Advisory Group

The *Fédération des Experts Comptables Européens* (FEE) started work at the beginning of 1987, taking over from two earlier European bodies: the *Groupe d'Etudes* (formed in 1966) and the *Union Européenne des Experts Comptables* (UEC, formed in 1951)

(see McDougall, 1979). Camfferman and Zeff (2009) investigate the formation and early years of the UEC.

FEE is based in Brussels and has member accountancy bodies throughout Europe. Its interests include auditing, accounting and taxation. It studies international differences and tries to contribute to their removal. Much of its work is connected with the EU, and it advises the European Commission on company law and accounting harmonization. If FEE can arrive at a consensus of European accountants, this gives it a powerful voice in Brussels, particularly if governments are disagreeing.

In 2001, FEE was the driving force behind the creation of the European Financial Reporting Advisory Group (EFRAG), which advises the EU Commission on the acceptability of new and amended IASB standards (see Chapter 5). From 2010, the EU Commission has been one of the funders of EFRAG, which enhanced its status as well as its budget.

4.4.6 Other regional bodies

The Inter-American Accounting Association (IAA) was founded in 1949 and includes the accountancy bodies of both the American continents. The Confederation of Asian and Pacific Accountants (CAPA) can be traced back to 1957, although it was not formally organized until 1976. It includes many countries (24 of them in 2015), and it may be that its members are too heterogeneous to constitute a 'viable accounting cluster' (Choi, 1981, page 31). So there may be problems in defining a region for the purpose of accounting harmonization.

In the case of CAPA countries, perhaps a more successful regional grouping involves a subset of them: the ASEAN Federation of Accountants (AFA) formed in Bangkok in 1977 (Choi, 1979). Choi (1981) suggested that one function of the AFA 'is to buffer individual ASEAN countries against the wholesale adoption of international accounting pronouncements that may not be suitable to local circumstances'. However, neither CAPA nor AFA seems to have had any effect on harmonization or the reduction of IASC or US influence. Craig and Diga (1996) examine the large differences in institutional structures in the ASEAN countries, which hamper regional harmonization. In 2009, the Asian-Oceanian Standard Setters Group (AOSSG) was set up, comprising bodies from 11 jurisdictions. By early 2015, this had grown to 26 jurisdictions, as diverse as Australia, Iraq and Turkey. The standard-setters ranged from professional accountancy bodies to independent trusts to government ministries. The work of AOSSG is closely related to the agenda of the IASB.

The Eastern, Central and Southern Africa Federation of Accountants (ECSAFA) was formed in 1990. It encourages the formation and development of accountancy bodies. It holds congresses, communicates with IFAC and carries out other joint activities. In 2011, the Group of Latin American Standard Setters (GLASS) was formed. The IASB's 'International Forum' (see 4.4.2) includes representatives from AOSSG, GLASS and EFRAG.

4.4.7 Other non-accounting bodies

One of the factors that drives accountants and their professional bodies towards better national and international standards is the possibility that governmental

Table 4.5 Some bodies concerned with harmonization

	Scope	
Sector	**World**	**Regional**
Governmental	UN, OECD, IOSCO	EU
Profession	IASC, IFAC	FEE
Independent	IASB	ESMA
Mixed	–	G4+1, EFRAG, AOSSG

bodies will intervene or gain the initiative. At present, with the regional exception of the EU, such international bodies have influence rather than power. The Organisation for Economic Co-operation and Development (OECD) researched and adopted recommendations for accounting practice: the 'Guidelines for Multinational Enterprises' (OECD, 1986, page 100). This mainly concerns disclosure requirements. It is voluntary, but it may influence the behaviour of large and politically sensitive corporations. There have also been surveys of accounting practices (e.g. OECD, 1980), but no agreement as to how to achieve harmonization. It seems clear that part of the OECD's aim in this area is to protect developed countries from any extreme proposals that might have come from the United Nations, which is interested in the regulation of multinational business.

In 1977, the UN published a report in this area, which proposed very substantial increases in disclosure of financial and non-financial items by transnational corporations. The UN went further and set up an 'Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting' (ISAR) in 1979. This has published some standards on disclosures by multinationals.

4.4.8 Classification of institutional harmonizers

Many harmonizing agencies have already been discussed in this chapter. It is useful to arrange some of these in a simple lattice (Table 4.5): by sector and by geographical scope. Table 4.5 is not exhaustive; as noted, there are other regional bodies. Further, the roles of the bodies differ markedly.

4.5 The International Accounting Standards Board

4.5.1 Reform of the IASC in 2001 and subsequently

The old IASC Board set up a 'Strategy Working Party' in 1997 to consider whether changes to its structure were needed after completion of the core programme for IOSCO. The working party's paper, 'Shaping IASC for the Future', was published at the end of 1998 (Camfferman and Zeff, 2007, Chapter 13). The proposals needed approval by the board (three-quarters majority required) and the member bodies of IASC (simple majority required).

The suggested reasons for a change included the following:

- reducing the load on the part-time board representatives, who had been working very hard, particularly for the previous two years as the core programme was completed;
- enabling a wider group of countries and organizations to be members of the board;
- increasing the degree of partnership with national standard-setters so as to accelerate worldwide convergence of standards.

The debate on reform concerned two competing ideas: independence and representativeness. This might also be seen as a struggle between Anglo-Saxon and continental European philosophy. The 'independence' argument is that good accounting standards are those designed in the public interest by a small group of full-time technical experts. Consequently, part-time standard-setters who work for accountancy firms or large companies are not sufficiently independent. The 'representativeness' argument is that legitimacy comes from the involvement of all interested parties, so that a large part-time board is appropriate.

The 1998 strategy paper contained a compromise by having a small technocratic executive board and a large representative supervisory Board. However, there was then a battle over which was to be more powerful. In the end, the independence argument won, partly because it was supported by the SEC, the most important member of IOSCO. Also, there was a threat that the FASB or the combined English-speaking standard-setters would try to take over world standard-setting from the IASC.

In December 1999, the board voted unanimously to abolish itself, and in May 2000 the member bodies confirmed this. The new structure came into operation on 1 April 2001. It is headed by the IFRS Foundation (formerly the IASCF) which is legally registered in the United States. It is controlled by trustees (22 of them in 2015), who have promised to operate in the public interest. The original trustees were selected by an appointments committee set up by the old board, and chaired by the chairman of the SEC. Trustees are now appointed by a Monitoring Group (see below). The politics of this are discussed in Chapter 10, Section 10.6.

The trustees are designed to be geographically representative (see Table 4.6). Their main tasks are to raise the necessary funds, and to appoint the board, initially comprising 12 full-time and two part-time members. The IASB was initially heavily dominated by former Anglo-Saxon standard-setters and former IASC Board representatives. Indeed, it has been suggested that other countries (e.g. France) are not well suited to engage with the IASB for cultural, legal and political reasons (Standish, 2003). This is discussed further in Chapters 5 and 10. The board changes slightly from time to time, but several of the initial members (see Table 4.7) were still in post until the middle of 2011. In 2009, the constitutional number of members was increased to 16, of whom three can be part-time. Four members each should come from Europe, North America and Asia/Oceania; one each from Africa and South America; and two from any area. Under the initial arrangements, only a simple majority was needed to pass standards, but this was increased to nine votes in 2005. In 2015, there were still 14 members.

The IASB and its secretariat remain based in London. There are four other bodies in the structure. The IFRS Interpretations Committee issues 'interpretations' of

Table 4.6 Geographical backgrounds of initial IASCF trustees

	Number
United States	5
Japan	2
Australia	1
Canada	1
South Africa	1
France	1
Germany	1
Switzerland	1
Brazil	1
China (Hong Kong)	1
Denmark	1
Italy	1
Netherlands	1
United Kingdom	1
	19

Table 4.7 Initial IASB members

Country	Number	Comment
United States	5 (or 3)*	2 former FASB + 1 former FASB trustee (and former IASC chairman) + 2 part-time
United Kingdom	2 (or 4) *	Both former ASB
Australia	1	Former AARF executive director
Canada	1	Former AcSB chair
South Africa	1	–
France	1	Former IASC Board
Germany	1	Former Daimler-Chrysler, which used US GAAP
Japan	1	Former IASC Board
Switzerland	1	Former IASC Board
Total	14	

Notes: *Two Board members had US work backgrounds but UK nationality.

AcSB = Accounting Standards Board of Canada. ASB = Accounting Standards Board of the UK. AARF = Australian Accounting Research Foundation, which provided the secretariat for the Australian standard-setter, the AASB. FASB = Financial Accounting Standards Board of the USA.

existing standards. These have to be approved by the IASB. The IFRS Advisory Council of analysts, preparers, auditors and others advises the IASB on its agenda and work programme. There is also an 'Accounting Standards Advisory Forum' (ASAF), set up in 2013. It has 12 representatives from national and regional standard-setting bodies and serves as a technical advisory group to the IASB. Lastly, a Monitoring Group was set up in 2009 in order to make the trustees accountable (see Chapter 10). The Monitoring Group contains the EU Commission, IOSCO, the SEC and others.

In 2009, the IASB issued 'IFRS for Small and Medium-sized Entities'. This has its own 'Implementation Group'. This version of IFRS is discussed in Chapter 12.

As mentioned above, some of the original IASB members served for 10 years. This included the first chairman, Sir David Tweedie. However, 10 years is the maximum term. Sir David had been the chief executive and the driver of both technical and political operations. The trustees decided to split the roles. From July 2011, the chairman (Hans Hoogervorst, a former Dutch Finance Minister and chairman of the Dutch stock market regulator) leads on political issues, and the vice-chairman (Ian Mackintosh, a former chairman of the Australian Public Sector Accounting Standards Board and of the UK's Accounting Standards Board) leads on technical issues. Camfferman and Zeff (2015) examine the first 10 years of the IASB in detail; their Chapters 3, 11 and 14 look at the developing organization over time.

4.5.2 The IASB's initial work

The IASB adopted all the old IASs and then began its work in 2001 in three main areas:

1. a new improvements project;
2. continuing projects;
3. major reforms.

The new improvements project led to exposure drafts in May and June 2002 designed to amend 14 standards and to withdraw IAS 15 (see Table 4.2). In the resulting revised standards of 2003 and new standards of 2004, a number of options were removed, such as LIFO (IAS 2) and correction of errors through income (IAS 8). The examination of IFRSs in Chapter 6 includes these amendments.

Projects on insurance accounting and exploration costs were begun by the IASC and are being continued by the IASB.

4.5.3 Convergence with the US

Much of the activity of the IASC in the 1990s had been concerned with persuading IOSCO to endorse IASs, and in particular persuading the SEC to accept IASs for foreign registrants on US exchanges. The setting up of the IASCF and the IASB was done in close consultation with the SEC. Despite this, the SEC took until 2007 to accept IFRSs for foreign registrants.

Nevertheless, the FASB and the IASB immediately began to work closely together. This was helped by the fact that two former FASB members (Tony Cope and Jim Leisenring) and some FASB staff joined the IASB, and a US representative (Michael Crooch) on the old IASC Board became a member of the FASB. Then, in 2002, one of the IASB members (Bob Herz) was appointed as the new FASB chairman. Also, in 2001/2, the large companies Enron and WorldCom were surrounded by huge accounting scandals, and Andersen (the most American of the big accounting firms) collapsed. This led to soul-searching in the US (see Chapter 8), including an investigation by the FASB into whether it should adopt a more 'principles-based' approach to standard-setting (like the IASB's) rather than setting detailed rules.

In late 2002, the IASB and the FASB announced a convergence project to try to eliminate as many differences as possible by 2005. IFRS 5 and IFRS 8 (see Chapter 6) were the first examples of international standards that were overtly designed to achieve convergence. Great efforts were made by the two standard-setters to eliminate differences and to avoid creating new ones. Convergence is discussed again in Section 5.5.

As a result of all this, the SEC announced in 2007 the acceptance of IFRS statements from foreign registrants without the need for reconciliation to US accounting practices. This applied for 2007 statements, i.e. filings in early 2008. Without reconciliation, the SEC will only accept full IFRS, not EU-endorsed IFRS or any other version. Then, in 2008, the SEC began consultation on the gradual replacement of US GAAP by IFRS from 2014 to 2016 (SEC, 2008).

However, the members of the SEC are appointed by the President of the United States. When President Obama took office in 2009, the SEC members were changed, and they announced that they were not bound by the proposals of their predecessors. Gradually it emerged that there would be no rapid adoption of IFRS in the USA, or even permission for US companies to use IFRS (SEC, 2012). This strategy is feasible for the SEC because the United States has the world's largest economy and capital market. Its GAAP is more detailed than IFRS and is highly-regulated.

One result of the SEC's decision of 2012 is that the FASB ceased to be the IASB's privileged partner on major projects, although the two bodies are still collaborating on some topics. More details about the US/IFRS convergence on various topics can be found in Chapters 6 and 8.

4.5.4 EU influence

As has already been mentioned in this chapter, the EU made IFRS compulsory for some purposes in 2005. The EU now sees itself as IASB's biggest 'customer' and therefore seeks influence. The increases in 2005 in the number of trustees and in the size of majority vote needed for IASB decisions were requested by the EU. Also, EU threats not to endorse a standard have to be taken seriously by the IASB. This is discussed in Section 5.2 and in Chapter 10.

4.5.5 The world standard-setter

The developments discussed above mean that the IASB has become the world's undisputed standard-setter, despite lack of adoption in the United States. As will be explained in Chapter 5, Australia approximately adopted IFRS for 2005 onwards, Brazil for 2010, Canada for 2011 and Russia for 2012. China has issued standards, based closely on IFRS, for reporting by listed companies (see Chapter 11). Japan now allows IFRS for certain companies, and many large Japanese companies have adopted IFRS (see Chapter 11). India announced convergence with IFRS in 2015.

However, many interesting IFRS issues remain to be discussed in this book, such as:

- the detailed content of IFRS and the remaining differences from US GAAP (see Chapters 6–9, 16 and 17);
- the emergence of different national responses to IFRS and of different national versions of IFRS practice (see Chapters 3, 5 and 7);

- the continuing use of national rules for many purposes other than the consolidated statements of listed companies (see Chapters 3 and 12–15);
- the strong political pressures exerted on the IASB, especially from the EU, and concerning in particular the use of fair values in the context of an economic crisis (see Chapters 6 and 10);
- the different national approaches to the monitoring and enforcement of IFRS (see Chapter 20).

SUMMARY

- Many parties are interested in international harmonization, including investors, stock exchanges and their regulators, multinational companies, accounting firms, trade unions and tax authorities.
- The scope for harmonization is great because the international variations in practice are very large. However, the obstacles are important, too. The fundamental causes of differences remain and these are backed up by nationalistic inertia.
- From the 1970s, a number of bodies were working for harmonization of accounting practices and disclosures, notably the IASC, which published a substantial list of international standards.
- IASs contained many options and gaps. However, with the support of stock market regulators (IOSCO), IASs greatly improved by the end of the 1990s. They were adopted by some countries and, in other countries, by some companies.
- There are other bodies concerned with harmonization on a worldwide or regional basis. For example, in 2000, the EU Commission proposed compulsory use of IASs for the consolidated statements of listed companies. A Regulation on this was approved in 2002 and came into force in 2005.
- The IASC was replaced in 2001 by a foundation and a mainly full-time IASB, which has been particularly influenced by its relationships with the FASB and the EU.
- As a result of many countries adopting IFRS or converging standards with it, the IASB has become the world's prime standard-setter.

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Useful websites

Asian-Oceanian Standard-setters Group	www.aossg.org
Committee of European Securities Regulators	www.cesr-eu.org
Confederation of Asian and Pacific Accountants	www.capa.com.my
European Accounting Association	www.eaa-online.org
European Commission	ec.europa.eu internal_market/accounting
European Financial Reporting Advisory Group	www.efrag.org
European Securities and Markets Authority	www.esma.europa.eu
Fédération des Experts Comptables Européens (FEE)	www.fee.be
IAS Plus	www.iasplus.com
International Accounting Standards Board	www.ifrs.org

International Federation of Accountants	www.ifac.org
International Organization of Securities Commissions	www.iosco.org
Organisation for Economic Co-operation and Development	www.oecd.org

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

4.1* Was the IASC successful? Explain your reasoning.

4.2* Which parties stand to gain from the international harmonization of accounting? What have they done to achieve it?

4.3 What arguments are there *against* the process of international harmonization of accounting?

4.4 Discuss whether the standards of the IASB should be directed to all companies or to some defined subset of companies.

4.5 Why have the UN and the OECD interested themselves in the harmonization of accounting? How have they gone about it?

4.6 Distinguish between harmony, harmonization and standardization.

4.7 Distinguish between *de jure* standardization and *de facto* standardization, giving examples of how one or both of them can be achieved.

4.8 The countries listed below are not covered in any detail in this book. Which of the six 'vital' countries (see Section 4.3.1) would you expect each to most closely resemble so far as accounting and corporate financial reporting are concerned? Explain why, referring to the discussions on classification of Chapter 3.

Belgium	New Zealand
Brazil	Nigeria
Italy	Saudi Arabia

Part II

FINANCIAL REPORTING BY LISTED GROUPS USING IFRS OR US GAAP

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5 The context of financial reporting by listed groups

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OBJECTIVES

After reading this chapter, you should be able to:

- explain the difference between adoption of IFRS and convergence of one accounting system with another;
- suggest why, and explain how, IFRS has been adopted for certain purposes in the EU;
- outline both high-level and detailed differences between IFRS and US GAAP;
- outline the issues involved with the convergence of IFRS and US GAAP and with adoption of IFRS in the United States;
- illustrate the scale of differences between national and international accounting rules;
- give an overview of how financial analysts might cope with international differences.

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* Some parts of Section 5.8 draw on material from a chapter in the 12th edition written by Stuart McLeay.

5.1 Introduction

Part II of this book (Chapters 5–10) examines the financial reporting rules and practices of the consolidated financial statements of listed companies. The reason for concentrating on this type of reporting here is that the EU Regulation of 2002 imposes IFRS on the consolidated statements of listed companies only, and US GAAP is only imposed by the SEC on listed companies, and the SEC is only interested in consolidated statements. Later in this book (Part IV), we look in more detail at financial reporting by individual unlisted companies, which is still largely carried out under national rules rather than using IFRS. However, some such national rules have been based on the IFRS for SMEs which, despite its name, is intended for unlisted companies. This is discussed further in Chapter 12.

A large proportion of the world's listed companies use either IFRS or US GAAP for consolidated statements. US listed companies use US GAAP. Australian, Brazilian, Canadian and Hong Kong listed companies use IFRS. EU companies use an EU version of IFRS. Japan allows IFRS from 2009/10. As may be seen from Table 1.5, these countries contain most of the world's listed companies.

Of large exchanges, this leaves only China (except Hong Kong) and India but, as will be shown in Chapter 11, China has largely converged its rules for listed companies with IFRSs. Also, some Chinese companies provide IFRS statements in addition to statements under Chinese national rules. In India, proposed adoption of IFRS has been delayed several times. In 2015, the Ministry of Corporate Affairs announced that companies would have to comply with an Indian version of IFRS, which would not be fully converged, for 2016 onwards. IFRS have also been adopted elsewhere, as explained in 5.3.2 below.

The detailed requirements of IFRS and US GAAP are examined in Chapters 6 and 8 respectively. In between these, Chapter 7 looks at the motivations and scope for different national versions of IFRS practice. This includes identifying the overt and covert options within IFRS; and looking at IFRS practice from 2005. Chapter 9 examines some key financial reporting topics in more detail, on a comparative IFRS/US basis. Chapter 10 tells the story of the pressures put on standard-setters by governments and companies.

Before all that, this chapter outlines some parts of the context. Section 5.2 examines the process of national adoption of, or convergence with, IFRS. Section 5.3 explains the EU mechanism for requiring the use of IFRS. Section 5.4 introduces the topic of differences between US GAAP and IFRS by looking at high-level differences (such as a concentration on rules rather than principles) and at examples of reconciliation. Section 5.5 examines convergence of US GAAP and IFRS. Section 5.6 uses published reconciliations to show the scale and type of differences caused by moving from national rules to IFRS or US GAAP. Then, Section 5.7 outlines how financial analysts cope with international differences. Later, Part VI of the book looks at monitoring and enforcement of the accounting rules, particularly in the context of listed companies.

5.2 The legal and political context of international standards

In some countries, the rules of financial reporting are contained in laws. In others, the rules are written in the private sector but enforced by laws. There are many possible variations.

International standards are written in the private sector. Countries require or allow them through various legal mechanisms, which are investigated in this chapter. Philosophically, it is easier to accept such standards in the English legal tradition than in the Roman legal tradition. Indeed, doubt has been cast on whether French institutions are well placed to interact with the IASB (Standish, 2003) and on whether Belgian companies are suited to responding to the IASB's proposals (Orens *et al.*, 2011). Questioning the 'legitimacy' of the IASB is more likely to come from a French person than a British one. Burlaud and Colasse (2011) question both the legitimacy and the theoretical foundation of the IASB; they are answered by Danjou and Walton (2012), in terms of the legal machinery used to endorse IFRS in the EU.

Posner (2010) explains the rise of the IASC and IASB to world prominence partly in terms of the sequence of political events. He traces the involvement of the US and European regulators in the rise of international standards. Some authors (e.g. Perry and Nöelke, 2005) have noticed the disproportionate attention the financial sector receives in the process. Naturally, regulators are more worried about banks than about department stores.

During the global financial crises of 2008 onwards, the IASB and the FASB were much criticized by various arms of government internationally, e.g. finance ministers and bank regulators. However, accounting academics have concluded that fair value accounting did not much contribute to the crisis (e.g. André *et al.*, 2009; Barth and Landsman, 2010; Amel-Zadeh and Meeks, 2013).

Chapter 10 looks in much more detail at the political aspects of standard setting.

5.3 Adoption of, and convergence with, IFRS

5.3.1 Adoption or convergence

It is important to distinguish between IFRS adoption and IFRS convergence. At the level of a jurisdiction, adoption means that national rules are set aside and replaced by a requirement to use IFRS directly. This can be done for all financial reporting or just for some (e.g. consolidated statements). In addition to IFRS adoption for some accounting purposes, countries might decide gradually to change their national accounting rules towards IFRS. This can be called 'convergence': a particular form of harmonization or standardization. The arguments for and against convergence are therefore covered in Chapter 4. Convergence of IFRS and US GAAP is examined in Section 5.6.

Chapter 14 includes an examination of those cases (e.g. the UK) where convergence of national rules with IFRS affects unconsolidated statements, in addition to the direct effects of IFRS on the consolidated statements of listed companies which must follow IFRS.

Further cases of convergence can be found in emerging economies. Such countries were briefly considered in Section 4.3.3 in the context of the IASC. More recently, convergence has moved faster. For example, China has closely followed IFRS for its listed companies (see Chapter 11).

5.3.2 Adoption by jurisdictions

Adoption of IFRS by changing the law to require the use of IFRS (at least for the consolidated statements of listed companies) has been the approach of very few jurisdictions. It has been done by Israel and South Africa. However, other famous 'adoptions' such as those of the EU (in 2005), Australia (in 2005) and Canada (in 2011), have complications, as will be explained in this section. Further adoptions include South Korea (2010), Brazil (2011) and Russia (2012). Now, over 100 countries require some form of IFRS for consolidated reporting by listed companies.

In the EU, it was thought to be legally and politically unacceptable to impose IFRS on companies, given that IFRS is issued in English only and that the IASB frequently changes the content of IFRS. Consequently, the EU Regulation 1606 of 2002 relates to IFRS as endorsed by the EU. Section 5.4 discusses this, and the audit opinions that result from it. The process of adoption of IFRS for Germany is examined by Haller and Eierle (2004) and for France, Germany and Italy by Delvaille *et al*. (2005).

Similarly, for 2005 onwards, all IASs and IFRSs have been turned into Australian standards (see 'AASB standards' at www.aasb.com.au): IFRS 1 is called AASB (Australian Accounting Standards Board) 1, and IAS 1 is called AASB 101, and so on. However, the AASB versions contain extra paragraphs and appendices, and originally some IASB paragraphs were deleted. For example, AASB 107 required the use of the direct method for the preparation of cash flow statements whereas IAS 7 also allows the indirect method. In 2007, the AASB changed its mind about this and re-inserted all the IFRS options. This was partly to avoid confusion at the SEC and elsewhere about whether Australian companies comply with IFRS. There are still several extra Australian standards with no IASB equivalents. The AASB standards claim that compliance with them will achieve compliance with IFRS. This may be true, but the Australian process seems like very close convergence with IFRS rather than exact adoption of IFRS. Incidentally, it was normal Australian practice until 2007 for auditors to refer only to compliance with Australian accounting standards. As a result, it was not clear to foreigners that IFRS was being obeyed. However, audit opinions on full IFRS are now also required.

In Canada, there is the issue of turning IFRS into Canadian French. Also, it was easier to leave all the laws of the provinces in place. These refer to the Handbook of the Chartered Professional Accountants Canada. IFRS (including a translated version) is now inserted into that Handbook.

These approaches to IFRS can perhaps be included as 'adoptions' because the differences seldom cause companies to depart from IFRS as issued by the IASB. Zeff and Nobes (2010) discuss these issues and present a diagram, reproduced here as Figure 5.1. On the right-hand side of it are examples of convergence rather than adoption, because companies are unlikely to end up complying with IFRS.

On the other hand, there is a problem with the scope of application in some countries. For example, in Canada in 2015, companies are allowed to use US GAAP

instead of IFRS for two reasons: (i) if they registered with the SEC in the United States, or (ii) if they operate in a rate-regulated industry. This led to about 130 exemptions from IFRS in 2015, including 20 per cent of the members of the main stock market index.

IFRS has, of course, been adopted by many countries which do not have large capital markets. Tyrrall *et al.* (2007) examine the use of IFRS in Kazakhstan. Al-Shammari *et al.* (2008) report on the use of IFRS in Arab states; and Assenso-Okofo *et al.* (2011) do so for Ghana. Both sets of authors find some non-compliance; an issue taken up in Chapter 20, which deals with enforcement. Hassan *et al.* (2014) looks at adoption in Iraq.

Camfferman and Zeff (2015, Chapters 4 and 15) examine the initial wave and subsequent adoptions of IFRS. Summaries of the worldwide use of IFRS can be found at www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx and at www.iasplus.com/country/useias.htm. Nobes (2013) cautions against exaggerated claims of the reach of IFRS, noting that often the adoptions relate to listed companies (or a sub-set of them) only or to consolidated statements only.

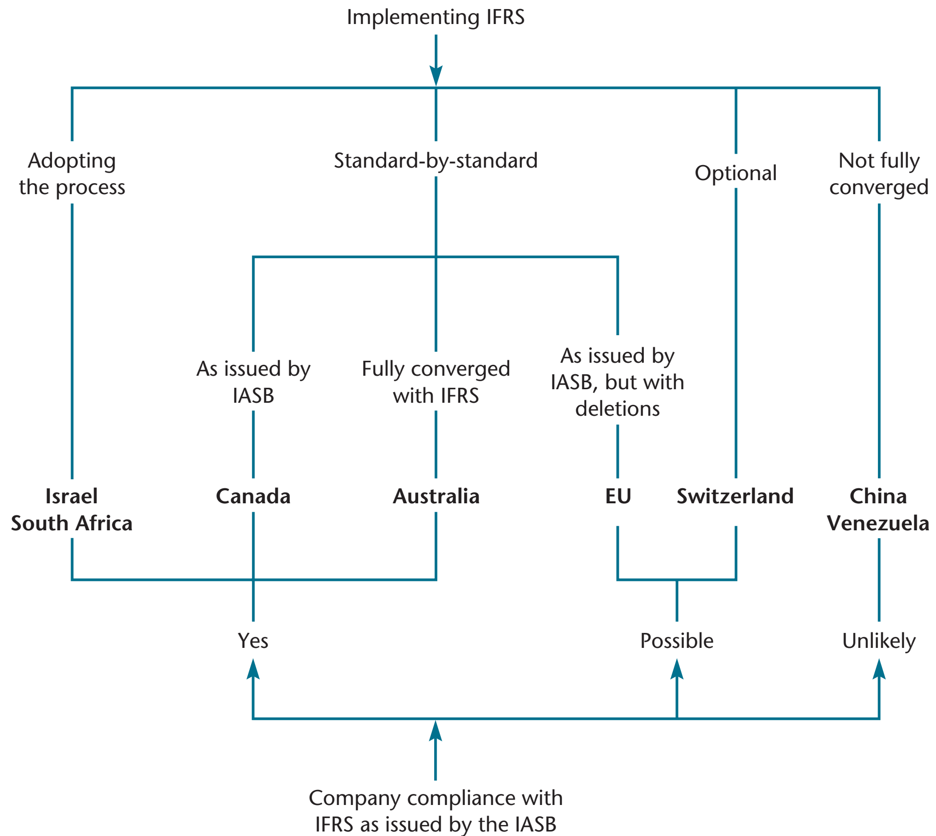

Figure 5.1 Methods of Implementing IFRS (consolidated statements of listed companies)

Source: Zeff, S.A. and Nobes, C.W. (2010) Has Australia (or any other jurisdiction) 'adopted' IFRS?, *Australian Accounting Review*, Vol. 20(2), pp. 178–184.

Hope *et al*. (2006) take an overview of the adoptions of IFRS that took place around the world at various dates. They find that IFRS adoption is more likely in countries that want to improve investor protection and access to their capital markets. Later, with many more adoptions to study, Ramanna and Sletten (2014) suggest that a country takes account of the other countries in its 'network', and that smaller countries have more to gain than large ones from IFRS adoption. As discussed in Chapter 3, the degree to which a country adopts IFRS (e.g. only for consolidated statements) also varies around the world, including within the EU.

A number of academic studies have investigated whether the mandatory move from national standards to IFRS has increased the quality of financial reporting. These are examined in Section 5.8.

5.3.3 Voluntary adoption by companies

In addition to compulsory use of IFRS, there can also be voluntary adoption. For example, in the EU, use of IFRS was allowed for consolidated statements in some countries before 2005. The most important example of this was Germany, where a number of companies volunteered to use international standards from the middle of the 1990s, partly to make it easier to raise capital in foreign markets. This followed the re-unification of Germany in 1990, which simultaneously offered opportunities for expansion and a shortage of funds due to a downturn in the economy and increasing taxes. Tarca *et al.* (2013) try out part of the model of Nobes (1998) by using German companies. They find that companies with a higher level of outside owners are indeed more likely to adopt IFRS.

IFRS is still allowed rather than required in Switzerland, and the majority of listed companies volunteer to use IFRS: 91 per cent of the members of the 130 companies in 'main standard' of the stock exchange (IFRS Foundation, 2015). Under certain easy conditions, IFRS has also been allowed in Japan from 2010, and is used by a number of large companies (see Chapter 11). Now, in the EU, unlisted companies are allowed, by the Regulation of 2002, to adopt IFRS for their consolidated statements if a member state allows or requires this, and most have allowed it. For unconsolidated statements, the Regulation also allows member states to allow or require IFRS. The response of member states has varied, as explained in Chapters 3 and 12.

Researchers have investigated the motivations that companies might have had for adopting IFRS before it was required. They conclude that voluntary adoption of IFRS was a signal of good-quality reporting. Cuijpers and Buijink (2005) looked at the determinants and consequences of the voluntary adoption of IFRS or US GAAP by EU-listed companies in 1999. They find that being listed on a US exchange and being geographically diverse are explanations for this. Ashbaugh (2001) and Leuz (2003) found that IFRS required greater transparency and uniformity than most national accounting systems did. The capital market effects of voluntary adoption are discussed in Section 5.8.

Francis *et al.* (2008) apparently study voluntary adoption of IFRS by unlisted companies from 56 countries in 1999/2000. They show large proportions of adoption in many countries, including several EU countries. Nobes (2010) argues that, because this was not legal at the time in the EU (see Section 5.4), Francis *et al.* cannot have been studying 'adoption' of IFRS.

5.4 IFRS in the EU

By the end of the 1990s, it was clear that harmonization led by the IASC was steaming ahead and that harmonization by means of EU Directives was being left behind. In 2000, the EU Commission launched a new approach by proposing that, by 2005, it should be compulsory for all listed companies in the EU to use IFRS for consolidated statements, thereby outlawing European domestic rules and US rules for this purpose. This initiative was part of a desire to strengthen the EU capital markets by establishing a standardized accounting system. Of course, US GAAP would have been available for this purpose but was regarded as too detailed, too rules-based (see Section 5.5) and too immune from European influence to be politically acceptable.

The move to IFRS was facilitated by the growing acceptance of international standards by large European companies and therefore by governments. For example, as mentioned earlier, from 1994 onwards a number of large German companies started to use international standards or US rules for their consolidated financial statements, partly in order to raise finance more cheaply. The position was formalized in Germany by a law of 1998 that allowed listed companies to do this without needing to comply with normal German accounting requirements.

The EU Commission published a draft Regulation in 2001, which was approved by the European Parliament and by the Council of Ministers in 2002. It required EU-listed companies to use international standards from 2005 for their consolidated financial statements. Member states were allowed to extend the deadline to 2007 for those companies that had already been using another acceptable set of standards (e.g. US GAAP) or whose only listed securities were bonds.

The legal and political opinion in Brussels is that new and revised standards cannot be endorsed in advance for EU use. Therefore, the Regulation set up an Accounting Regulatory Committee (ARC) to help the Commission to consider whether changes to IFRS can be endorsed in the EU (see http://ec.europa.eu/finance/accounting/governance/committees/arc/index_en.htm). ARC contains governmental representatives from all EU member states. This is a way of achieving EU influence over the IASB, but it has brought into existence a form of EU-endorsed IFRS that is slightly different from IFRS as issued by the IASB. To assist the Commission in reaching a view on new or amended IFRSs, a private-sector committee of auditors, preparers and others was established in 2001, called the European Financial Reporting Advisory Group (EFRAG). One of EFRAG's tasks is to liaise with the IASB to try to ensure that the standards take account of issues seen as important in Europe. Van Hulle (2005) explains the endorsement system.

In 2006, yet another feature was added to this process. The Commission set up a small body of independent experts (called the Standards Advice Review Group) to give it advice that is not influenced by governments (unlike ARC) or by audit firms and companies (unlike EFRAG). The EU also takes part in the Monitoring Group that appoints trustees of the IFRS Foundation (see Chapter 4).

In 2004 most of the existing content of IFRS was endorsed. However, the Commission refused to endorse the whole of IAS 39 on financial instruments. The Regulation

does not appear to allow the Commission to amend a standard but, in effect, that is what it did. The endorsed version of IAS 39 did not contain the option to extend 'mark to market' accounting to any financial instruments (i.e. to value them at fair value and take the gains and losses to income). Also, the endorsed IAS 39 has more flexibility on the use of hedge accounting. However, in 2005, the IASB amended IAS 39 in order to restrict the range of instruments that can be fair valued. This was accepted by the EU, so that the difference between IAS 39 and the EU-endorsed version concerns only hedge accounting. Whittington (2005) examines the endorsement of IAS 39. Financial instruments are considered further in Chapters 8 and 9 and the political aspects of standard setting on financial instruments are examined in Chapter 10.

In 2005, another problem emerged because the EU refused to endorse IFRIC 3, on accounting for emission rights. This time, rather than being a political issue, the EU considered the technical solution to be wrong. However, the IASB withdrew IFRIC 3 in June 2005, thus removing the problem. A further case occurred in 2007 when a motion was passed in the European Parliament opposing endorsement of IFRS 8 (operating segments). However, IFRS 8 was eventually endorsed, more than one year after the IASB had published it.

The endorsement process also involves translating IFRS into many EU languages; a problem discussed in Section 7.3. Partly for this reason but more for technical and political reasons, endorsement often takes more than one year. Therefore, there are always several elements of IFRS that have not been endorsed. This generally does not create a problem for EU companies because new or amended standards usually have in-force dates that are at least a year after publication. However, there are exceptions to that. For instance, IFRIC Interpretation 12 was required to be used as part of IFRS for financial statements for years ended 31 December 2008, but it was not endorsed until 29 March 2009, after many groups had issued their 2008 statements. In this case, as IFRIC 12 is not inconsistent with the rest of endorsed IFRS, it could be adopted early as part of EU-IFRS.

A more important example of timing problems concerned the suite of consolidation standards: IFRSs 10 to 12 and revised IASs 27 and 28, which were published by the IASB in May 2011 for compulsory use in 2013 onwards. These documents were not EU-endorsed until December 2012, and they came into force in the EU for 2014. Consequently, for 2013, the new standards were allowed but not compulsory in the EU. Some EU companies adopted for 2013; for example, because they wanted to comply with 'IFRS as issued by the IASB' for SEC purposes (see discussion of the Glaxo audit report below). Other EU companies were complying by accident because the new standards led to no changes in accounting. For some EU companies, the new standards led to changes (e.g. in the scope of consolidation), so they did not comply with IFRS in 2013. For most EU companies, it was not possible to tell whether or not they were complying with IFRS. The most important current example is that IFRS 9 (*Financial instruments*) was issued by the IASB in 2009 (with later amendments) but, by late 2015, the EU had not endorsed it. The EFRAG website (www.efrag.org) shows the current position on endorsements under 'Endorsement status'.

The fact that EU-endorsed IFRS is not the same as IFRS has led to confusion and to audit problems. The auditors' opinion on GlaxoSmithKline's consolidated statements for 2014 is as follows:

In our opinion, the Group financial statements defined below:

- give a true and fair view of the state of the Group's affairs at 31 December 2014 and of the Group's profit and cash flows for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- have been properly prepared in accordance with the Companies Act 2006 and Article 4 of the IAS Regulation.

Separate opinion in relation to IFRSs

As explained in Note 1 to the financial statements, the Group in addition to complying with its legal obligation to comply with the IFRSs as adopted by the European Union, has also applied the IFRSs as issued by the International Accounting Standards Board (IASB).

In our opinion the group financial statements comply with IFRSs as issued by the IASB.

Several points need to be made about this:

- The auditors refer to a 'true and fair view'. This is because EU laws still require directors to ensure that financial statements give a true and fair view (see Sections 2.4 and 13.2), and auditors to give an opinion on that. Interestingly, IAS 1 requires instead a 'fair presentation' (see Section 6.2), but a practical assumption is that this is the same thing as a true and fair view. In other languages (e.g. French and Italian), the problem goes away because 'true and fair view' and 'fair presentation' have been translated as the same expression (e.g. *image fidèle* in French).
- The auditors refer to IFRS as adopted by the EU and, in a separate opinion, to IFRS as issued by the IASB. This is because the company is listed on the New York Stock Exchange, so it needs the second audit report to satisfy the SEC, which accepts only US GAAP or 'IFRS as issued by the IASB' (unless the company provides a reconciliation to US GAAP). Glaxo can comply with both forms of IFRS because it has chosen not to take advantage of the extra permission to use hedge accounting in the EU version of IAS 39. It must not adopt new IFRS until the EU endorses it (unless there are no incompatibilities), and it must adopt EU-endorsed IFRS before the EU requires it if this is necessary to comply with IFRS.
- The auditors refer to the Companies Act. The Act exempts a company following IFRS from national standards and from most of national law on accounting. However, some aspects of law (e.g. the requirement to appoint auditors and to publish statements) are still in force.
- The auditors refer to the IAS Regulation. This is the EU Regulation of 2002 that requires listed companies to follow IFRS instead of (most of the) national rules for their consolidated statements.

The legal context of IFRS reporting is investigated by Nobes (2009), with particular reference to the consolidated statements of UK listed companies. That article also

looks at two examples (one French, one British) of departures from standards on the grounds of fair presentation.

Another aspect of the EU's adoption of IFRS was that the EU became the IASB's 'best customer' during the first decade of the twenty-first century. It sought to exercise influence on the IASB in many ways, as may be seen from the discussion of endorsement above. An extreme version of this was seen in October 2008 when, under threat that the EU would change IFRS for its own purposes, the IASB amended IAS 39 to allow re-classifications of financial assets (see Sections 6.4.4 and 9.4). This was done with no due process and no consultation of other constituents. The political aspects of this are discussed in Chapter 10. Now that many more countries have adopted IFRS, such EU influence has been reduced.

In 2014, the EU launched a public consultation on whether its 'IAS Regulation' had been successful. There were 200 replies, and support was overwhelming from all countries. Some respondents called for faster endorsement and some for compulsory extension of IFRS beyond consolidated statements. In May 2015, the Commission issued a summary of the responses: http://ec.europa.eu/internal_market/consultations/2014/ifrs/docs/summary-of-responses_en.pdf. Then, in June 2015 the Commission sent a report to Parliament: http://ec.europa.eu/finance/accounting/docs/ias-evaluation/20150618-report_en.pdf. It is clear that IFRS is here to stay in the EU, with no major amendments proposed to the EU endorsement mechanism or to the scope of IFRS application.

It seems clear that compulsory use of IFRS for listed companies' consolidated statements may lead to the end of national standard setting in some countries (an issue taken up in Section 12.3). The Regulation allows member states to extend the use of IFRSs compulsorily or optionally to unlisted companies and to unconsolidated statements, as examined in Part IV of this book.

5.5 IFRS/US differences

5.5.1 Overview

This section takes an overview of the differences between US GAAP and IFRS. First, three high-level differences are examined: principles versus rules (in 5.5.2), the availability of options (in 5.5.3), and departures from historical cost (in 5.5.4). Then an indication of the practical importance of the differences is provided by looking at published reconciliations from IFRS to US GAAP (in 5.5.5). Section 5.6 examines convergence between the two systems.

5.5.2 Principles and rules

The US regulators and the standard-setters (FASB) had believed that US GAAP was of higher rigour and quality than IFRS. However, the collapse of Enron and its audit firm, Andersen, in 2001–2 was one of the factors that led to a reconsideration of how to set accounting standards in the United States (Eaton, 2005). In 2002, the Financial Accounting Standards Board published a consultative document seeking views on whether it should move more towards principles rather than rules (FASB, 2002).

In the case of Enron, one of the main accounting issues was that many controlled entities (special purpose vehicles) with large liabilities were not consolidated. The US rule on the scope of entities to be consolidated (in APB Opinion 18) was based on the ownership of more than half the voting shares, rather than on the IASB's principle of 'power to govern the financial and operating policies' (in IAS 27 at the time). Furthermore, unlike in IAS 1, there is no requirement (or even permission) in the US to depart from the rules of standards on the grounds that the result is misleading; that is, there can be no override of rules by the principle of fair presentation. This was confirmed by the FASB in 2008 with a standard (SFAS 162) on the hierarchy of principles. However, it seems unlikely that the FASB will be able to move fully to the IASB's style of standards because it would require the re-writing of all the US literature and the re-training of US accountants and auditors.

The issue led to an interesting academic debate. Schipper (2003) points out that the FASB tries to use principles when it is writing the rules. Nelson (2003) suggests that standards are at various points on a continuum from principles to rules. Rules include 'specific criteria, "bright line" thresholds, examples, scope restrictions, exceptions . . . implementation guidance' (page 91). Nelson suggests that rules might be useful for reducing imprecision but can lead to excessive complexity and to the structuring of transactions by companies in order to avoid a threshold (e.g. to omit something from consolidation or to escape from the capitalization of lease liabilities). As a case study, Bradbury and Schröder (2012) examine the standards on borrowing costs, finding more exceptions and complexity in US GAAP than in IAS 23.

Dennis (2008) points out the distinction between standards that are based on principles (but might be full of rules) and those that contain principles rather than rules. Nobes (2005) suggests that, for several standards, the quantity of rules could be reduced by identifying better principles, which would often lead to more precision and less structuring at the same time. He suggests, for example, abandoning the distinction between operating and finance leases (see also McGregor, 1996 and Nailor and Lennard, 1999) and treating government grants as immediate income (Westwood and Mackenzie, 1999). These can be compared to the current requirement of IFRS in Chapter 6. The FASB decided in 2004 to work towards 'objectives-oriented' standards that would state objectives clearly and minimize exceptions and 'bright-lines' (FASB, 2004).

Benston *et al.* (2006) suggest that it is difficult to have a principles-based approach when there are requirements for the use of fair value (see below), because detailed guidance for preparers is in practice needed. They also argue for the introduction of an 'override' for fair presentation into US GAAP.

5.5.3 Options, including fair value

Another aspect of the greater detail of US GAAP is that it contains fewer explicit options than IFRS does. There used to be more IFRS options before many were gradually removed by the IASB. Some examples of the surviving options in IFRS and US GAAP are given in Table 5.1. For all but the first item, the US GAAP column shows no option whereas IFRS has one. The bracketed chapter numbers refer to the chapters in this book that cover the issues in more detail. Chapter 7 contains a more detailed look at the options in IFRS, and at how they have been taken up differently in different countries.

Table 5.1 Some options in IFRS and US GAAP

	IFRS	US GAAP
LIFO (Chapter 8)	No	Yes
Presenting assets in order of increasing liquidity (Chapter 2)	Yes	No
Showing interest paid as financing cash flow (Chapter 7)	Yes	No
Property, plant and equipment (PPE) and investment property at fair value (Chapter 6)	Yes	No
Intangible assets with active market at fair value (Chapter 6)	Yes	No

One aspect of this high-level difference is the greater *permission* in IFRS compared to US GAAP to use fair value rather than historical cost. There are also *requirements* to use fair value in IFRS for unlisted investments (under IAS 39 or IFRS 9) and for biological assets (IAS 41). These do not apply in US GAAP. This is in addition to the requirement to use fair value for certain other financial assets and liabilities (which does apply in US GAAP).

5.5.4 Reconciliations between IFRS and US GAAP

The accounting differences between IFRS and US GAAP can be illustrated using published reconciliations. Those from IFRS to US GAAP were required by the SEC from foreign registrants until 2007. So, the sources of these data are the annual reports of companies using IFRS for their consolidated financial reporting that are also listed on a US exchange.

Tables 5.2 and 5.3 show reconciliations (of income and equity) for the German company Bayer, and the French company Alcatel-Lucent, for the last year that the companies provided them. A few companies carried on this process for longer than

Table 5.2 Reconciliations from IFRS to US GAAP by Bayer, 2006 (€m)

	Income	Equity
As reported under IFRS	1,695	12,851
Business combinations	79	950
Pensions	(168)	11
In-process research and development	(1,375)	(1,454)
Asset impairment	23	(114)
Early retirement program	(27)	74
Revaluation surplus	4	(58)
Other	(17)	2
Deferred tax effect on adjustments	67	3
Minority interest	(12)	(84)
As reported under US GAAP	269	12,181

Source: Adapted from the *Bayer Annual Report, 2006*. Bayer AG, Leverkusen, Germany. Reproduced with permission.

Table 5.3 Reconciliations from IFRS to US GAAP by Alcatel-Lucent, 2006 (€m)

	Income	Equity
Under IFRS	(176)	15,493
Business combinations, goodwill	(403)	4,433
Development costs	39	(146)
Restructuring	(47)	12
Sale and lease-back	(50)	(245)
Compound instruments	39	(840)
Pensions	61	837
Other	(20)	2
Tax effect	(33)	(262)
Under US GAAP	(590)	19,284

Source: Adapted from Annual Report 2006, Alcatel-Lucent, reprinted with permission of Alcatel-Lucent USA Inc.

required. For example, Philips (the Dutch electrical company) continued until 2008, as shown in Table 5.4. As may be seen, there were several adjustments. These sometimes cancel out, so that the net effect seems small even though several of the differences are large.

A few companies also show reconciliations the other way – from US GAAP to IFRS. This particularly relates to the move by some European companies (especially German ones) from using US GAAP to using IFRS in response to the EU Regulation of 2002. In some cases these companies moved to IFRS as late as 2006 or 2007 because the Regulation allowed member states to allow this for companies that had been

Table 5.4 Reconciliations from IFRS to US GAAP by Philips, 2008 (€m)

	Income	Equity
Under IFRS	(91)	15,544
Development costs	(154)	(357)
Amortization of development	300	–
Pensions	(54)	889
Goodwill impairment	67	339
Goodwill capitalization	–	81
Intangibles	24	(152)
Financial income/expenses	(313)	–
Equity accounted investees	–	(10)
Tax effects of adjustments	(30)	(122)
Other	87	31
Under US GAAP	(186)	16,243

Source: Adapted from the Annual Report 2008 of Philips International BV.

using US GAAP. An example, shown as Table 5.5, is the reconciliation by the Norwegian energy company, Norsk Hydro, in its 2007 report. A second example relates to a Canadian company, which moved from US GAAP to IFRS in 2011, and therefore disclosed a reconciliation relating to 2010, as in Table 5.6.

The major differences in the rules are listed in Section 8.9, after IFRS and US GAAP have been examined in Chapters 6 and 8. The largest adjustments in Tables 5.2 and 5.3 are caused by differences in consolidation rules. These are also taken up again in Chapter 16.

Section 5.3 referred to several papers that showed how adoption of IFRS could improve the usefulness of accounting compared to some national systems. However, is IFRS better than US GAAP? One way of trying to decide is to consider the arguments above in this section. For example, there are clearly problems with the US rules-based approach: it leads to complex rules and to the structuring of transactions. On the other hand, IFRS still perhaps has too much flexibility. An academic approach would ask which system enables better predictions of earnings or is better correlated with share price movements. This is discussed in 5.8.5 below.

Table 5.5 Reconciliations from US GAAP to IFRS for Norsk Hydro (N kroner millions)

	Net income (2006)	Equity (1.1.2006)
According to US GAAP	17,391	95,495
Pensions	375	(6,012)
Financial instruments	(113)	(792)
Property	(50)	310
Other	128	761
Minority interests	202	981
According to IFRS	17,933	90,743

Source: Compiled by the authors from data available in Annual Report 2007 of Norsk Hydro AS.

Table 5.6 Reconciliations from US GAAP to IFRS for Barrick Gold Corporation (US$ millions)

	Income (2010)	Equity (31.12.2010)
As reported under US GAAP	3,274	20,734
Capitalized costs	334	952
Reversal of impairment	84	139
Hedging	(39)	(13)
Capitalized interest	(5)	(130)
Other	17	(264)
Tax effects	(83)	(201)
As reported under IFRS	3,582	21,217

Source: Prepared by the authors from the company's 2011 annual report.

5.6 Convergence of IFRS and US GAAP

Section 5.3 explained the difference between adoption of a set of rules and convergence with them. It also looked at convergence of national rules with IFRS. Section 5.5 examined several aspects of the differences between IFRS and US GAAP. This section looks at convergence between them.

Esty and Geradin (2001) note that liberalization of markets has been a major feature of recent years. They examine, for several topics (but not accounting), the arguments for and against allowing competition between two or more sets of regulations. Competition might allow alternative solutions to be tested and refined. It might also guard against dictatorial regulatory behaviour and against inefficient bureaucracies. However, international coordination might reduce inefficiency caused by companies having to operate under the different rules of different jurisdictions, and it might reduce the chance that jurisdictions might compete to attract companies by having the most lax rules ('a race to the bottom').

In this context, it is interesting to note that US GAAP and IFRS are both amongst the world's toughest sets of rules, in terms of coverage of topics, elimination of choices and required disclosures. Clearly, however, US GAAP is the tougher of the two. Despite this, as noted earlier, many foreign companies had chosen to list on US exchanges even they had to comply with US GAAP.

US GAAP has always been one of the greatest influences on the content of international standards, as explained at the end of Chapter 6, after that content has been examined in some detail. Also, the FASB and the IASB have been volunteering to reduce regulatory competition for over a decade, for the sake of continued standardization and the attendant advantages (see Chapter 4). In September 2002, the FASB and the IASB announced plans to achieve convergence in a document called the Norwalk Agreement. The proposal was that some detailed differences should be removed rapidly and then other differences gradually. These plans were updated in a Memorandum of Understanding published by the FASB and the IASB in February 2006, and that was further updated in 2008. In response to complaints from companies and auditors about the exhausting speed of change, the boards announced a slowing down of convergence in 2010.

Table 5.7 shows examples of convergence. In 2005, the SEC announced that it could now foresee the day when it would accept IFRS statements from foreign companies without reconciliation to US GAAP. In 2007, this proposal was put into effect (SEC, 2007), applying immediately, i.e. for the 2007 statements filed with the SEC in 2008.

Schipper (2005) examined the implications of US/IFRS convergence. She suggested that there would be pressure on the IASB to issue more detailed interpretations, and

Table 5.7 IFRS and US convergence

IFRS moves to US GAAP	US GAAP moves to IFRS
Discontinued operations, IFRS 5 (2004)	Exchanges of assets, SFAS 153 (2004)
Segment reporting, IFRS 8 (2006)	Accounting policies, SFAS 154 (2005)
Borrowing costs, IAS 23 (revised 2007)	Fair value option, SFAS 159 (2007)

pressure for greater enforcement (see Chapter 20). De Lange and Howieson (2006) examined the institutional structures of the FASB and the IASB. They predicted that the FASB would dominate standard setting and that there was little incentive for US companies to adopt IFRS. This prediction appeared to be overtaken by events when the SEC (2008) announced consultation on proposals to require IFRS for 2014 statements onwards and allow it for some registrants for 2009 statements onwards. Nevertheless, as SEC members are political appointees, they can change when the President changes, as happened at the beginning of 2009. The new SEC was less enthusiastic about the proposal to adopt IFRS.

In May 2011, the SEC staff issued a paper that outlined a possible approach towards gradually incorporating IFRS into US GAAP over several years. The final version (SEC, 2012) made it clear that IFRS would not be adopted quickly. The document contained no 'road map' and no timetable. There were not even any proposals to *allow* IFRS for US companies.

In the meantime, some further convergence has been going on. Both boards issued converged standards on business combinations in 2007/8 (see Chapter 16), and on revenue recognition in 2014 (see Chapter 6). There was also a joint revision to the first parts of the conceptual framework in 2010 (see Chapter 6). Nevertheless, after the 2012 SEC announcement, the IASB and FASB gave up trying to produce fully converged standards on insurance contracts and leases, and the IASB started to revise the conceptual framework by itself. The FASB was removed as the IASB's privileged partner, although the two boards still co-operate extensively.

5.7 Reconciliations from national rules to US GAAP or IFRS

Some examples of reconciliation from other national rules to US GAAP were given in Section 1.1. Section 2.9 gives other examples, and lists academic studies that calculate the average percentage adjustments to earnings or net assets for many companies. Further examples of adjustment are given here. They relate to 2004 because that was the last year for which EU-listed companies produced consolidated statements under national rules. Table 5.8 shows the enormous adjustment from UK profit for Vodafone for the first half-year that it prepared IFRS information. The difference is largely due to the elimination of the expense of amortization of goodwill (see Chapter 6).

Another example, this time from German to US rules, is given as Table 5.9. The table combines the reconciliations for income and for shareholders' equity provided by the large chemical company headquartered in Germany, BASF. The income reconciliation for 2004 contains some fairly large adjustments that happen to cancel out. However, for 2003, the US version of profit was 45 per cent higher than the German version. Several of these issues are taken up again in Chapters 9 and 12.

Some researchers have investigated whether these reconciliations provide value relevant information. Barth and Clinch (1996) found that, for Australian and UK companies, the reconciliations did provide useful information. Harris and Muller (1999) provide further such evidence. Lang et al. (2006) suggest that companies' foreign accounting numbers show more earnings management than do their US-adjusted numbers.

Table 5.8 Vodafone income statement (£m)

	Six months to 30.9.2004			
	UK GAAP	Presentational adjustments	Accounting adjustments	IFRS
Revenue	16,796	(54)	–	16,742
Operating (loss)/profit	(1,615)	(598)	6,972	4,759
Exceptional non-operating items	22	(22)	–	–
Non-operating income and expenses	–	16	–	16
Net financing costs	(291)	91	(35)	(235)
(Loss)/profit before tax	(1,884)	(513)	6,937	4,540
Tax	(1,559)	865	(163)	(857)
Exceptional deferred tax credit	572	(572)	–	–
Minority interests	(324)	220	36	(68)
(Loss)/profit for the period	(3,195)	–	6,810	3,615
Basic (loss)/earnings per share	(4.77p)			5.40p

Source: Adapted from Vodafone income statement in the *Vodafone Interim Announcement, 2004*.

Table 5.9 Reconciliations by BASF from German to US rules for 2004 (€m)

	Income	Equity
As reported income under German GAAP	1,883.0	15,765.0
Adjustments required to conform with US GAAP		
Capitalization of interest	(4.5)	472.7
Capitalization of software developed for internal use	(53.5)	128.3
Accounting for pensions	41.0	924.3
Accounting for provisions	(8.1)	244.4
Accounting for derivatives and long-term foreign currency items	194.5	3.2
Valuation of securities at market values	6.8	191.5
Valuation adjustments relating to companies accounted for under the equity method	(161.6)	39.0
Inventory valuation	(3.4)	18.9
Reversal of goodwill amortization	148.7	469.5
Other adjustments	29.8	58.6
Deferred taxes and recognition of tax effects of dividend payments	(210.4)	(810.8)
Minority interests	0.5	(345.5)
In accordance with US GAAP	1,862.8	17,159.1

Source: Adapted from the *BASF Annual Report, 2004*, p. 92. BASF SE, Ludwigshafen, Germany. Reproduced with permission.

5.8 International financial analysis

5.8.1 Introduction

Before 2005, the use of IFRS was rare amongst listed companies. Australian companies used Australian GAAP, French companies used French accounting and so on. The accounting rules of China, Japan and the USA had not been converged with IFRS. Consequently, users of financial statements faced major problems when trying to cope with international differences. Chapter 1 deals with several matters related to this:

- the extent to which companies list on foreign exchanges,
- the provision of annual reports in several languages,
- the publication of reconciliations to US GAAP or to IFRS (also discussed in Section 2.9).

This chapter has already discussed one issue of relevance to the analysis of financial statements: the value relevance of reconciliations (Section 5.7). This section introduces the following issues relating to analysis of financial statements in an international context:

- foreign language and foreign currency;
- is financial information reliable?
- ratios in international analysis; and
- analysis and the capital market.

5.8.2 Foreign language and foreign currency

A very obvious problem (e.g. for Europeans interested in Chinese or Japanese companies) is language. As mentioned in Section 1.2, some companies publish annual reports in more than one language. It is common for listed Chinese and Japanese companies to publish reports in English. As explained later (in Chapter 11), sometimes these 'convenience translations' are not exact translations of the originals. Some international companies provide glossaries of terms to assist readers. This is done, for example, by BT (British Telecom).

There is also the issue of foreign currencies. That is, annual reports are presented in different currencies. This is quite a different issue from accounting for transactions in foreign currencies and from accounting for foreign subsidiaries (see Chapter 17). Some companies publish 'convenience currency translations'. For example, some Japanese companies publish their financial statements in US dollars as well as Japanese yen. Generally, they use the spot rate at the balance sheet date, but some use the average for the year. Of course, the great majority of companies show figures in one currency only. So, analysts have to make their own choices of rates at which to translate numbers in order to make international comparisons.

5.8.3 Is financial information reliable?

A key issue in international financial analysis is whether or not the information in financial reports is equally reliable in different jurisdictions. We expect good regulation and effective accounting standards to increase the precision of financial statements. To achieve this, regulators and standard-setters eliminate options and restrict the number of rules that require judgements, and include more detail to provide guidance in those cases where such judgements on accounting policy have to be made. However, when laws and standards are weak or their enforcement is lacking (see Chapter 20), this gives managers opportunities to mask their firm's economic performance, either upwards or downwards, by overstating earnings and assets in order to conceal unfavorable circumstances or by understating them in order to create reserves that will cushion future costs.

Investor protection laws are important in this respect. These enable shareholders to hold managers accountable for their actions, at least by forcing them to communicate poor results fully in current earnings. In highly competitive circumstances, it is not surprising that managers might try to defer loss recognition to future periods, because in the long run this will shift the consequences on to subsequent generations of managers beyond their own tenure. So, strong investor protection tends to make earnings lower, because losses have to be recognized immediately whereas gains are recognized only when they are realized.

The protection of minority shareholders can also have an impact on the quality of reported financial results. In firms with closely held shares, the interests of the managers and the majority shareholders are likely to be aligned and the shareholders will not necessarily rely on financial reporting in order to monitor the managers, as they have access to sources of information within the firm. Also, if the managers and controlling owners are able to dominate the firm, they will have incentives to conceal their own benefits, especially if these have a negative effect on the minority shareholders and other parties. Indeed, such managers are likely to use earnings management to conceal the firm's performance from outsiders, especially by overstating earnings in a way that hides unfavorable losses that would prompt outside interference. So earnings management is expected to be more pervasive in countries where the legal protection of outside investors is weak.

An international accounting study that sheds light on this is Leuz *et al*. (2003). Figure 5.2 shows one of their results. Here, we compare countries in Europe with the USA, highlighting Germany and Italy on the one hand and the UK and USA on the other. Earnings management does seem to be more prevalent when the legal protection of shareholders is weaker and ownership concentration is higher. For example, Germany and Italy scored low on investor protection and high on ownership concentration, and the Leuz *et al*. (2003) measure of earnings management is relatively high in these circumstances. Nevertheless, we should try to disentangle accounting manipulations by way of creative accounting from those changes to earnings that are caused by real transactions, which are undertaken in order to achieve the desired earnings figure. Interestingly, the level of such 'real' earnings management may be expected to increase with the reduction of discretion through tighter regulation and standards. When the legal system restricts the scope for accounting creativity, this will increase the marginal benefit of real earnings management (see Ewert and Wagenhofer, 2005).

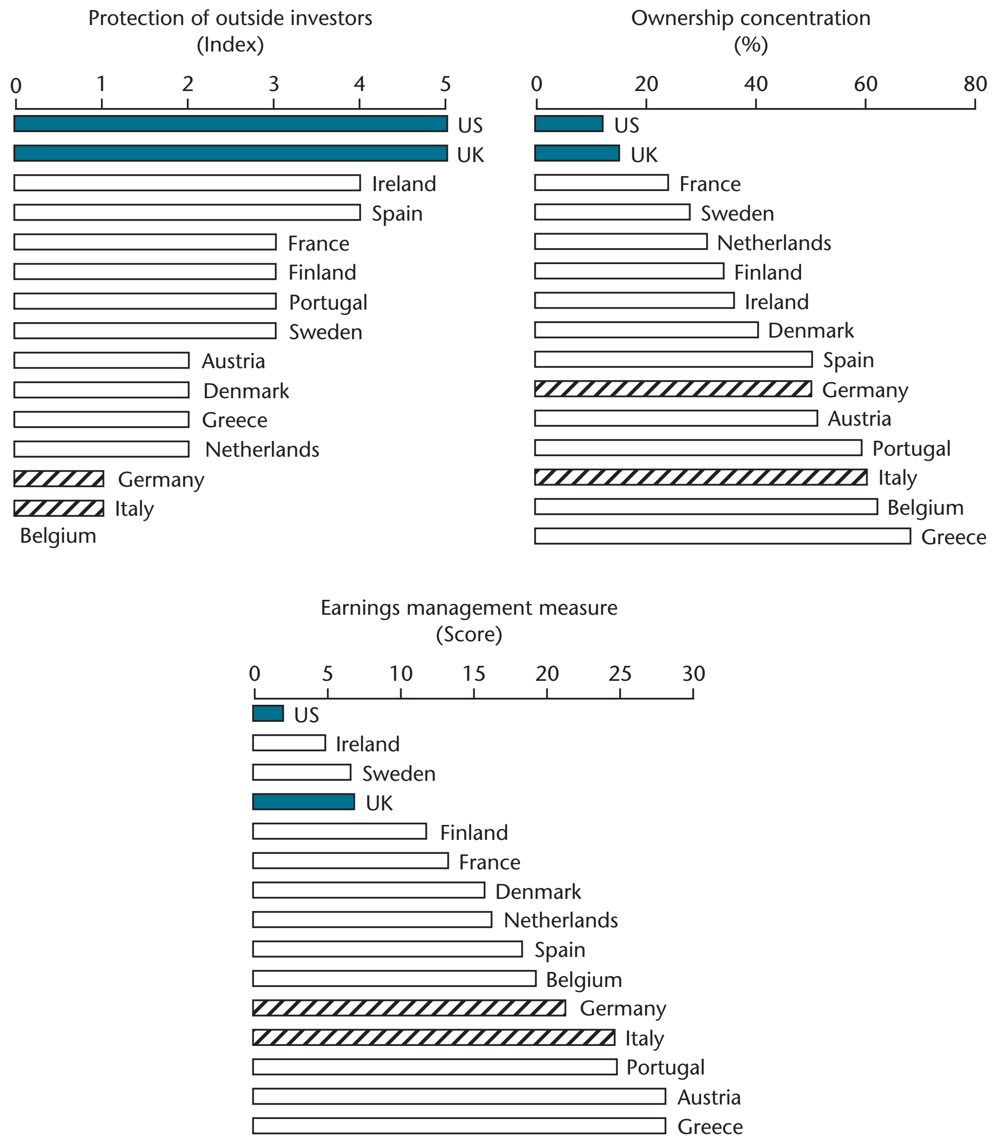

Figure 5.2 Investor protection, ownership concentration and earnings management

5.8.4 Ratio analysis in an international context

As with analysis in a domestic environment, international analysis includes the use of ratios. Whenever an international accounting difference is mentioned in this book, one important question to think about is: why does this matter? One answer might be the effect on ratios. For example, the use of LIFO for inventory valuation can have a large effect on balance sheets (see Chapter 8). The significance of this can be gauged by calculating the effect on profitability (return on assets) ratios, gearing/leverage ratios or liquidity ratios.

Many companies try to help analysts by publishing ratios and 'key performance indicators'. Often, companies also disclose 'non-GAAP' measures of earnings and other accounting numbers. However, there are no internationally (or even nationally) agreed definitions of any of these things. Therefore, users of financial statements need to be especially careful when making international comparisons.

In order to help foreign analysts, the Japanese 'convenience translations' (mentioned in 5.8.2 above) re-arrange items in the income statement. For example, 'extraordinary items' cannot be shown in IFRS income statements but they are common in Japan. So, in convenience translations, these amounts are absorbed into other headings.

A much more ambitious and universal version of this process of standardizing presentation is called XBRL (extensible business reporting language). This is an accounting version of 'html' which is a mark-up language for displaying items on the World Wide Web. XBRL attaches labels to items of accounting data (e.g. the figure for intangible assets in a balance sheet). This enables users of information from several companies or countries to re-arrange it all to a standard format for financial analysis. A full set of labels and their structure is called a taxonomy (or classification). See www.xbrl.org.

The IFRS Foundation has prepared an IFRS taxonomy. In the United States, the SEC introduced a requirement in 2009 for listed companies to use XBRL. In the UK, Her Majesty's Revenue and Customs (HMRC) has required XBRL for corporate tax purposes from 2011. The use of XBRL should make analysis, including ratio analysis, much easier on a comparative international basis. There is a danger, though, that analysts might forget that accounting numbers are measured very differently from one accounting system to another, and that XBRL does nothing to solve that problem.

5.8.5 Financial analysis and the capital market

Choi and Levich (1990) reported that companies made many voluntary disclosures in order to assist cross-border analysts. In the end, though, they suggested that some investors avoided certain foreign countries because of difficulties in interpreting the financial statements. An alternative to that extreme approach is to adjust accounting data to a common benchmark. As explained above, a few companies provide data adjusted for presentation (e.g. Japanese convenience translations) or for measurement issues (e.g. reconciliations to US GAAP).

The relevance of financial disclosures, and corporate earnings in particular, to share price movements appeared to vary from one stock market to another. In Europe the harmonization process of the 1980s did little to iron out these differences (Alford *et al.*, 1993; Saudagaran and Meek, 1997). Research by Joos and Lang (1994) considered the effect of the EU accounting Directives on the relationship between earnings and stock prices, investigating other indicators as well, such as return on equity, the price to earnings multiple and the book to market ratio. All these authors report no evidence of convergence in the value relevance of earnings and other accounting numbers after the implementation of the Directives into national legislation.

In the case of German firms, the investment analysts' association (DVFA) attempted early on to address these shortcomings by devising a formula to arrive

at adjusted profit figures for use in market valuation. Research by Pope and Rees (1992) and by Harris *et al.* (1994) found that these DVFA adjustments significantly increased the explanatory power of earnings in the period following changes in German accounting law. In a study of London-based analysts, Miles and Nobes (1998) reported on the adjustments that are made for international accounting differences. They find that adjustments are often not made for many important differences. Clatworthy and Jones (2008) similarly found that UK-based analysts rely extensively on sources of information other than annual reports, especially for companies from countries with weak capital markets.

The value relevance of accounting information (the extent to which financial statements are useful to investors in understanding share prices) has also been linked to institutional conditions in the jurisdiction in which the reporting entity is based. In this context, before the switch to IFRS, Ali and Hwang (2000) suggested that analysts should look for the 'usual culprits' when asking whether financial disclosures are likely to be less relevant to investors in a particular country. Is the financial system bank-oriented? Is the government the source of accounting rules and regulations? Is the accounting system aligned with taxation? A useful approach in this respect is to consider the incentives related to these institutional factors and how these might predictably affect accounting income. For example, when governments establish and enforce national accounting standards, this is typically with representation from business associations, banks and employee organizations. At the firm level, this is reflected in stakeholder governance, which Ball *et al.* (2000) contrast with shareholder governance. Under the former, where payouts to stakeholders are likely to be more closely linked to accounting income than otherwise, managers will have greater discretion in deciding when gains and losses will be incorporated in accounting income, and direct communication with insider groups should solve the information asymmetry between managers and stakeholders. In contrast, under a shareholder governance model, where greater reliance is placed on external monitoring in the capital market, there will be more demand for *timely* public disclosure, and *conservative* earnings computation should make managers more immediately accountable.

Timeliness and conservatism are two of the key properties of accounting numbers that have been thought to differ between accounting regimes (Pope and Walker, 1999). Timeliness is the extent to which current accounting income incorporates economic income, which can be proxied by the change in market value of equity. Conservatism is defined in these academic papers as the extent to which losses are recognized more quickly than gains, i.e. that unrealized decreases in asset value are written off immediately whereas unrealized gains are not recognized. This is sometimes called 'conditional conservatism'. Figure 5.3 shows the relationship between market price changes expressed as returns and earnings expressed as an earnings yield, based on the results in Ball *et al.* (2000). Accounting conservatism is indicated by a steeper slope for bad news in the market (a negative return) relative to good news (a positive return).

The situation in Germany is of particular interest. As noted above, it had been widely presumed that accounting in Germany was particularly conservative because increases in asset values could not be written into the financial statements. Also, in the past, provisioning provided ample discretion to smooth earnings by reducing

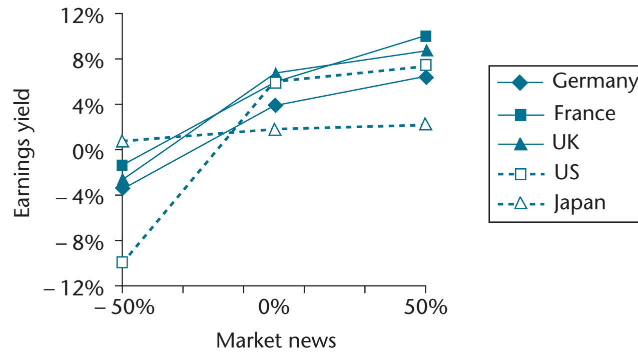

Figure 5.3 Accounting conservatism and timeliness

income in good years (Gray, 1980). However, Germany should no longer be characterized as having an extremely conservative regime, given this market-based analysis. In Japan, another typical insider system, accounting is neither timely nor conservative. Earnings do not incorporate economic income at all: the bad news slope on market news that is negative and the good news slope on market news that is positive are both close to zero. At the other extreme, in the United States (a typical outsider system), accounting is seen to be more timely and the most conservative.

Foreign firms that cross-list in the USA show more evidence of earnings management, and less evidence of the timely recognition of losses, than their counterparts in the USA (Lang *et al.*, 2003). Bushman and Piotroski (2005) found that firms in countries with high-quality judicial systems reflect bad news in reported earnings faster than firms in countries with low-quality judicial systems, that strong public enforcement of securities law discourages 'overstatements' by slowing recognition of good news in earnings, and that diffuse equity holding that separates the ownership of capital from the management of capital is also consistent with more conservative earnings.

However, the increasing influence of IFRSs may be changing the value relevance of accounting information, in Europe at least. Some researchers have found that use of IFRSs constrains earnings management (Barth *et al.,* 2008). However, Van Tendeloo and Vanstraelen (2005) find that, for German firms, the voluntary adoption of IFRSs was not associated with less earnings management for 1999 to 2001. Hung and Subramanyam (2007) look at German adopters from 1998 to 2002. They find that total assets are higher under IFRSs than under German accounting and that the adjusted numbers were more closely associated with company valuation, although adjusted income numbers were not.

Consider goodwill, research and development costs and the revaluation of property, plant and equipment. These are three financial statement line items that are characterized by uncertainty about their future benefits, and which, under IFRSs, are now measured in a way that can differ considerably from the domestic accounting practices that were in place prior to the mandatory introduction of international standards in the EU. Using measures of these items first under local GAAP and then under IFRSs in the year of mandatory IFRS adoption, Aharony *et al*. (2010) strongly conclude that the lower the compatibility between former domestic standards and

IFRSs, the greater the incremental value relevance to investors from switching to IFRSs. Using a different research design, Schleicher *et al*. (2010) show that, before IFRS adoption, the reported capital expenditure by firms operating in insider economies is highly sensitive to lagged reported cash flow, whereas the investment of those operating in outsider economies is insensitive to lagged cash flow. Post-IFRS, this is no longer the case. Nevertheless, there is no solid evidence yet that the decline in country differences is fully attributable to accounting change, as there have been simultaneous institutional and enforcement improvements.

Houqe *et al.* (2012) study 46 countries, finding that earnings quality does increase after mandatory adoption of IFRSs, but that this relies on good-quality investor protection. The value relevance of changes to individual accounting topics can also be studied. Chalmers *et al.* (2011) find that the extra information on intangible assets produced by Australian companies when they moved to IFRS improved accounting. Marra *et al.* (2011) find that the adoption of IFRS by Italian listed companies was associated with an increase in the ability of audit committees and independent directors to control earnings management.

Daske (2006) does not find any evidence of reduced cost of capital for German firms that adopted IFRS or US GAAP from 1993 to 2002. However, Ernstberger and Vogler (2008) show that the cost of capital for German firms fell significantly for those that adopted IFRS or US GAAP instead of German accounting from 1998 to 2004. Li (2010) studies EU companies more generally, and looks at the effects of transition to IFRs in 2005; he finds a significant fall in the cost of capital.

An important task undertaken by the financial analyst is to provide investors not only with 'superior' earnings per share (EPS) figures when the quality of reported figures is deemed to be low, but also with estimates of *future* EPS. It is sometimes argued that analysts' forecast errors (i.e. the difference between the forecasted earnings and the actual earnings that are reported at a later date) are too large for investors to rely on analysts' predictions. The evidence suggests, however, that analysts are able to provide estimates of future EPS that can assist in market valuation. Such forecasting requires a sense of where a business and its competitors are going, and the results of a survey carried out by Moyes *et al.* (2001) indicated international differences in the relative importance of the various factors taken into account. These authors point to a more international focus by the UK analysts and a greater reliance on guidance from management in the United States, but clearly the accuracy with which analysts are able to forecast EPS will also be affected by a number of other issues, as discussed below.

Basu *et al*. (1998) found that more informative disclosure environments increase forecast accuracy. Hope (2003) found that better forecast accuracy is associated with strong enforcement of accounting rules in a country. Forecasting is more difficult when earnings are volatile, and the behaviour of reported EPS is also influenced by accounting practices that either smooth or exaggerate the underlying earnings behaviour. Research by Capstaff *et al.* (2001) demonstrates that analysts' earnings forecasts generally outperform naive forecasts but are typically optimistic and increasingly inaccurate the longer the forecast horizon. These researchers also find that analysts' forecasts are at their best for firms in the Netherlands and least successful in the case of firms in Italy.

Ashbaugh and Pincus (2001) found that greater differences between a country's GAAP and IFRS decrease forecast accuracy in that country. Guan *et al*. (2006)

discovered something similar for differences from US GAAP. Bae *et al*. (2008) found that accounting differences from IFRS affect the accuracy of analysts' forecasts and the number of analysts that follow a particular company. Companies that use accounting systems furthest from IFRS have fewer analysts and a worse forecast accuracy. Glaum *et al*. (2013) also confirm an increase in forecast accuracy for German firms adopting IFRS. The same even applies to companies moving from UK GAAP to IFRS (Choi *et al*., 2013), even though the two GAAPs might have been thought to be similar.

5.8.6 Some conclusions on analyzing IFRS financial statements

A number of papers and reports summarize the empirical findings on the effects of IFRS adoption (e.g. Brüggermann *et al*., 2013). There is widespread agreement that mandatory adoption of IFRS, particularly by countries with strong investor protection, has improved accounting quality. Ahmed *et al*. (2013) conduct a meta-analysis of the research on IFRS adoption: they find the value relevance of earnings numbers has increased, but not that of balance sheet numbers. Analysts' forecast accuracy has also increased. The meta-analysis does not show a major effect of such factors as legal origin or enforcement strength. The most extensive survey of the research can be found in ICAEW (2015).

Figure 5.4 shows a representation of the complex links involved in assessing the effects of IFRS adoption. The three lozenges represent types of regulatory change. The top right lozenge refers to such issues as improvements in monitoring and enforcement, which coincided with IFRS adoption. The top two lozenges affect key qualities

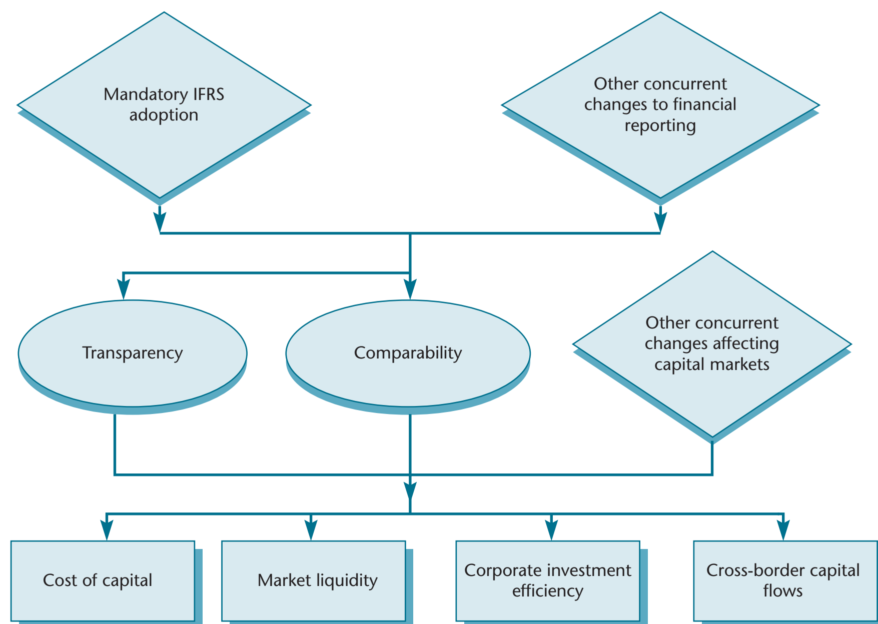

Figure 5.4 Improvement in financial reporting
Source: adapted by the authors from a figure kindly provided by Brian Singleton-Green of the Institute of Chartered Accountants in England and Wales.

of financial reporting, such as transparency and comparability. Enhancement of these should, in turn, lead to improvements in the economic issues in the four oblong boxes at the bottom of the figure, such as lower cost of capital. However, these might also have been affected by factors in the lower right lozenge, which would include the global financial crisis. Researchers have therefore had difficulty in being sure that any economic effects have been caused by adoption of IFRS.

In conclusion, international comparison of financial statement information still requires a good understanding of the way in which judicial systems, securities laws and ownership structures can create incentives that influence the managers of firms in the way they draw up their financial statements, and lead to contracting and monitoring demand for credible accounting information. However, as firms increasingly exploit the integrated global market, these national accounting differences tend to have less effect (Raonic *et al.*, 2004). Moreover, recent evidence suggests that earnings quality is increasingly dependent on the characteristics of the firm itself and of the industry in which it operates, rather than being determined by country differences (Gaio, 2010).

There is a danger that, when IFRS has become very widespread, analysts will think that accounting data are internationally comparable. However, as will be shown in Chapter 7, there are national versions of IFRS practice. Ball (2006) warns that, despite the adoption of IFRS, accounting will still vary internationally because:

> The fundamental reasons for being sceptical about uniformity of implementation in practice is that the incentives of preparers (managers) and enforcers (auditors, courts, regulators, boards, block shareholders, politicians, analysts, rating agencies, the press) remain primarily local. (page 15)

SUMMARY

- Most of the world's listed companies use IFRS or US GAAP for their consolidated financial reporting.
- In addition to the adoption of IFRS by some countries for some purposes, the rules in some countries are being converged with IFRS.
- International standards have to be endorsed before adoption in the EU, and some elements of standards have not been endorsed.
- There are differences between IFRS and US GAAP. These include a greater tendency of US GAAP to contain detailed rules and to forbid valuations above cost.
- Published reconciliations between IFRS and US GAAP illustrate some large remaining differences.
- Convergence has also been under way between those two 'international' benchmarks.
- The differences between national rules and IFRS or US GAAP can also have large effects on financial statements.
- There are several especial problems for analysis in an international context. Only some of these are addressed by the gradual adoption of IFRS.

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Whittington, G. (2005) 'The adoption of international accounting standards in the European Union', *European Accounting Review*, Vol. 14, No. 1, pp. 127–53.

Zeff, S.A. and Nobes, C.W. (2010) 'Has Australia (or any other jurisdiction) "adopted" IFRS?', *Australian Accounting Review*, Vol. 20, No. 2, pp. 178–84.

Useful websites

European Commission	http://ec.europa.eu/internal_market/accounting/ias_en.htm
European Financial Reporting Advisory Group	www.efrag.org
Financial Accounting Standards Board	www.fasb.org
IAS plus	www.iasplus.com
International Accounting Standards Board	www.ifrs.org
International Organization of Securities Commissions	www.iosco.org
Securities and Exchange Commission	www.sec.gov

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

5.1* Distinguish between harmonization, standardization, convergence, adoption and EU endorsement.

5.2* Using the reconciliations of this chapter and the information in Chapter 2, comment on the adjustments necessary when moving from German or UK accounting to US or IFRS accounting.

5.3 Explain the advantages and disadvantages of writing accounting standards containing principles rather than rules.

5.4 Discuss the high-level differences between IFRS and US GAAP. Was the SEC right to demand reconciliations of IFRS to US GAAP from foreign companies that are listed on US exchanges?

5.5 Explain the arguments for and against allowing the IASB and the FASB to compete in the provision of accounting standards. Which arguments are the stronger?

5.6 Access the website of GlaxoSmithKline (www.gsk.com) to explain the differences disclosed in its annual reports between US GAAP and IFRS and UK GAAP from 2004 to 2006. Could these differences (summarized in Tables 1.1 and 1.2) have been smaller if the company had made other choices of options available within IFRS and UK GAAP? Is the size of the differences influenced by the fact that GSK is a pharmaceutical company?

5.7 How do preparers and users of annual financial statements of listed companies cope with international differences?

5.8 Two approaches to measuring conservatism are discussed in the chapter: the comparison of profit figures under different GAAPs; and asymmetric recognition of good and bad news. What are the advantages and disadvantages of each approach?

5.9 Is worldwide application of IFRS going to solve the problems of international financial analysis?

6 The requirements of International Financial Reporting Standards

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Appendix 6.1 An outline of the content of International Financial Reporting Standards

OBJECTIVES

After reading this chapter, you should be able to:

- outline the overall objectives of financial reporting under IFRS, including the underlying assumptions;
- discuss the meaning of relevance and faithful presentation and how they might conflict;
- explain how revenue and other types of income are measured and presented;
- explain the definition of assets and liabilities and when such items should be recognized in statements of financial position;
- outline the measurement methods used under IFRS for various assets;
- give examples of various types of liabilities that would be recognized under IFRS;
- explain the basic features of group accounting for subsidiaries, joint arrangements and associates;
- discuss the main national influences on the content of IFRS.

6.1 Introduction

Chapters 4 and 5 examined the purposes of standardization and its progress so far. The history and structure of the International Accounting Standards Committee (IASC) and the International Accounting Standards Board (IASB) were reviewed there. However, those chapters did not deal with the detailed requirements of the standards, which is the province of this chapter.

A list of IFRSs (including IASs) is shown as Table 6.1. There are some numbers missing because some of the original standards have been replaced (see Table 4.2). Also, most standards have been revised since their original issue. Many options were removed in 2003, and more have gradually been removed since then.

In addition to the standards, there are 'Interpretations' that must be complied with. Older ones are in an 'SIC' series and newer ones (from 2002) in an 'IFRIC' series. These documents are drafted by a committee of the IASB but need approval from the Board itself. In 2010, the committee's name changed again to the IFRS Interpretations Committee. Bradbury (2007) examined IFRIC's operating procedures and its output in its first five years.

This chapter looks at the content of most of the standards under seven sections, each of which deals with related topics. Consequently, the coverage here is not in the numerical order of the standards. A few current standards are left out where, for example, they are related to a specialized sector (e.g. IFRS 4 on insurance contracts). However, Appendix 6.1 at the end of the chapter gives a summary of the contents of all the standards in numerical order.

The main purpose of this chapter is to outline and summarize the requirements of IFRS, which is a necessary step towards understanding IFRS. The chapter makes one further contribution (Section 6.9) by explaining the main national sources of the content of IFRS. Other steps towards understanding IFRS include knowing about:

- the legal and political aspects of the bodies involved in creating and enforcing IFRS (see Chapters 4, 5 and 10);

Table 6.1 IASB standards (January 2016)

IAS	1	Presentation of financial statements
IAS	2	Inventories
IAS	7	Statement of cash flows
IAS	8	Accounting policies, changes in accounting estimates and errors
IAS	10	Events after the reporting period
IAS	11	Construction contracts [being replaced by IFRS 15]
IAS	12	Income taxes
IAS	16	Property, plant and equipment
IAS	17	Leases [being replaced by IFRS 16]
IAS	18	Revenue [being replaced by IFRS 15]
IAS	19	Employee benefits
IAS	20	Accounting for government grants and disclosure of government assistance
IAS	21	The effects of changes in foreign exchange rates
IAS	23	Borrowing costs
IAS	24	Related party disclosures
IAS	26	Accounting and reporting by retirement benefit plans
IAS	27	Separate financial statements
IAS	28	Investments in associates and joint ventures
IAS	29	Financial reporting in hyperinflationary economies
IAS	32	Financial instruments: presentation
IAS	33	Earnings per share
IAS	34	Interim financial reporting
IAS	36	Impairment of assets
IAS	37	Provisions, contingent liabilities and contingent assets
IAS	38	Intangible assets
IAS	39	Financial instruments: recognition and measurement [being replaced by IFRS 9]
IAS	40	Investment property
IAS	41	Agriculture
IFRS	1	First-time adoption of IFRSs
IFRS	2	Share-based payment
IFRS	3	Business combinations
IFRS	4	Insurance contracts
IFRS	5	Non-current assets held for sale and discontinued operations
IFRS	6	Exploration for and evaluation of mineral resources
IFRS	7	Financial instruments: disclosures
IFRS	8	Operating segments
IFRS	9	Financial instruments
IFRS	10	Consolidated financial statements
IFRS	11	Joint arrangements
IFRS	12	Disclosure of interests in other entities
IFRS	13	Fair value measurement
IFRS	14	Regulatory deferral accounts
IFRS	15	Revenue from contracts with customers
IFRS	16	Leases

- the spread of compulsory and voluntary use of IFRS across the world (see Chapter 5);
- whether IFRS are well written, logical and internally consistent (see below and Chapters 9, 16 and 17);
- the practical application of IFRS requirements (see Chapters 9, 16 and 17);

- whether or not there are different national versions of IFRS practice (see Chapter 7);
- the differences between IFRS and national accounting systems, especially US GAAP (see Chapters 8, 11 and 15);
- how compliance with IFRS is enforced (see Chapter 20).

Given this chapter's main purpose, we cannot deal with all these issues here. In Sections 6.4–6.8, there are boxes headed 'Taking it further' in which we explain where in this book the particular topic in IFRSs is examined in more detail.

Before the description, it is worth noting that IFRS, like any set of accounting rules, has been subject to plenty of technical criticism. For instance, management has strongly criticized IAS 39 (see Chapter 5); academics have suggested, for example, that IFRS have '57 serious defects' (Haswell and Langfield-Smith, 2008a and 2008b), although this has been questioned by Bradbury (2008) and Nobes (2008). Some of the more complex topics are examined further in Chapters 9, 16, 17 and 18.

6.2 The conceptual framework

6.2.1 Outline and overall objective

The IASB's *Conceptual Framework for Financial Reporting* is an updated version of a framework originally published by the IASC in 1989. That owed much to the framework published in the United States by the Financial Accounting Standards Board from the late 1970s onwards (see Chapter 8 for more detail). The IASB and the FASB worked jointly on a project to revise the *Framework*. In 2010, revised chapters on the 'objective' and 'qualitative characteristics' of financial reporting were issued, as was an exposure draft on 'the reporting entity'. In 2013, the IASB issued a discussion paper (DP) on the other unrevised content:

- elements of financial statements,
- recognition, and
- measurement.

The DP also included a chapter on presentation and disclosure. Barker (2014) made suggestions for improving the DP. In 2015, the DP's proposals were further refined by the IASB and published as an exposure draft (ED). This section of the book is based on the ED, as amended by decisions of the IASB during meetings in 2015.

In its Chapter 1, the *Framework* assumes that the main objective of 'general purpose' financial reporting is to give useful information to various users (typically investors) in order to improve their financial decisions. The decisions include assessing the stewardship of management. The information includes that on the entity's resources and the changes in those resources. For the latter, the accruals basis is useful. That is, for measuring performance, transactions should be recognized when they occur, not by reference to the date of the receipt or payment of cash. However, both ways of calculating may be relevant for prediction of the future. The balance sheet and the income statement are based on the accruals convention, but the cash flow statement is not.

The IASB's *Framework* is mainly designed for use by the Board when setting accounting standards. However, it is also for preparers and auditors of financial statements as they interpret accounting standards and for users as they read the statements. The *Framework* itself is not a standard, but IAS 1 (*Presentation*) turns many of the ideas of Chapter 1 into requirements. The same applies to the contents of Chapter 2, which discusses the qualities of good accounting information (see 6.2.2 below). Chapter 3 deals with the reporting entity. For example, in the context of consolidated statements, the reporting entity includes all controlled entities. Chapter 3 also notes that accounting is usually done under the assumption that an entity is a going concern, although preparers and auditors should, of course, check that this is appropriate. This convention has a major influence when evaluating particular items in the balance sheet. For example, if an entity depreciates an item of plant over 10 years, then it is assuming that the plant will have a useful life *to the entity* of 10 years, which assumes that the enterprise will continue in operation for at least 10 years.

6.2.2 Relevance and faithful representation

Chapter 2 of the *Framework* deals with the qualitative characteristics that good accounting information should have. There are two fundamental characteristics: relevance and faithful representation, and four 'enhancing' ones. This can be summarized as in Figure 6.1.

Relevance

In order to be useful, information must be relevant to its purpose, which is seen to be economic decision-making. This requires predictions of future cash flows, which can be based partly on relevant past and present information in statements such as the balance sheet and income statement. Incidentally, IFRS now refers to these statements as a 'statement of financial position' and a 'statement of comprehensive income'. However, practice by companies varies, and we will generally use the shorter terms in this book, except where the context requires formal precision.

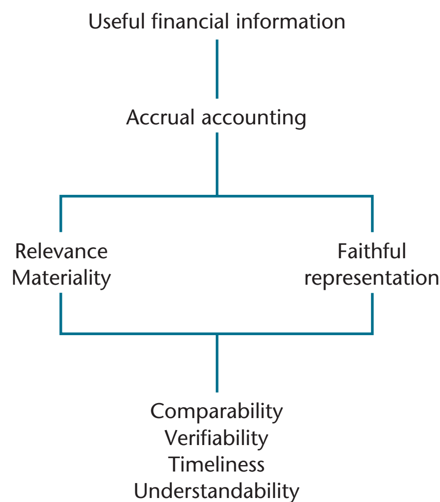

Figure 6.1 IASB/FASB qualities

In order to be relevant information must be important enough to affect decisions, that is it must be 'material' in amount, in the context of the entity and the decisions being taken.

Faithful representation

The readers of financial statements should not be misled by the contents of the statements. Transactions, assets and liabilities should be shown in such a way as to represent as well as possible what underlies them. For example, a balance sheet should not show an item under the heading 'assets' unless it meets the definition of an asset. This assumes that readers have a good grasp of the concepts used. Faithful representation also implies a lack of errors that would affect the interpretation of the accounting numbers.

Part of faithful representation is that the accounting information should reflect the substance of transactions if that is different from their form. This is sometimes expressed as showing the economic substance of transactions rather than their legal form. However, this is too simple. The exact economic substance will rest on the exact legal arrangements. The issue here is to see through any superficial legal or other arrangements to the real economic effects.

To take an example, suppose that an entity signs a lease which commits it to paying rentals to use a machine for the whole of the expected life of the machine. This is very similar to borrowing money and buying a machine, in the sense that the entity (under either arrangement) has control over the operational use of the machine and has an obligation to pay money. The legal form is that the enterprise does not own the machine or have any outstanding unpaid debt currently owing, but the substance is that it has an asset and a liability (see the definitions in the next section).

Similarly, if an enterprise sold a machine to a financial company and immediately leased it back for most of its life, the legal form is that there has been a sale but the substance is that the enterprise still has the asset. However, the economic substance in these cases still rests on the contents of the legal documents signed by the lessee.

The *Framework* says that, to be faithful, information also needs to be free from error, complete and neutral. Freedom from error does not imply complete accuracy. For example, many accounting numbers rely inevitably on estimates, but the process of estimation should be sound.

Information should be as complete as possible within the constraints of materiality. Any important omissions would cause the financial statements to be misleading. However, the rule-makers (in this case, the IASB) should bear in mind that some demands for information may be too costly to the enterprise. The benefits of the information should outweigh the costs of producing it. Chapter 2 says that the cost constraint is 'pervasive'.

Neutrality means freedom from bias. With this in mind, the age-old convention of prudence was deleted from the *Framework* in 2010. However, this led to complaints, particularly in Europe, where prudence is enshrined in EU Directives (see Chapter 13). However, prudence had always been heavily constrained in the Framework, being merely 'the exercise of caution when making judgements under conditions of uncertainty'. In this weak form, it was put back in the Framework. In practice, accounting standards seem to require more prudence than that, e.g. see the discussions about provisions and impairment in this chapter.

A stronger form of conservatism can still be found in some countries (see Chapter 15) in order to protect certain users (including creditors) from the risk of making the financial statements look too good, particularly given the excessive optimism of some businessmen. Recognizing that a number of estimates are involved in accounting, the accountant, according to this convention, should ensure the avoidance of overstatement by deliberately setting out to achieve a degree of understatement. This requires that similar items, some of which are positive and some of which are negative, should not be treated symmetrically. Hellman (2008) examines conservatism in the context of IFRS and suggests that the requirements of IASs 11, 12 and 38 (on contracts, deferred tax and development costs) lead to temporarily less conservatism than under some European practices.

6.2.3 Enhancing qualitative characteristics

Comparability, including consistency

Financial information is unlikely to be relevant unless it can be compared across periods and across companies. This requires as much consistency as possible in the use of methods of measuring and presenting numbers; it requires also that any changes in these methods should be disclosed.

Verifiability

This means that different observers should be able to come to approximately the same view about whether a faithful representation is being given by the information. So, information must be able to be checked in various ways.

Timeliness

Relevance is increased if information is up-to-date. This raises a common problem that there may be an inconsistency between concepts. For example, the need to ensure verifiability of information may slow down its publication. The regulators of financial reporting in many countries set time limits for the publication of financial statements and require reporting more than once a year.

Understandability

Clearly, information cannot be relevant unless it can be understood. However, in a complex world, information may have to be complex to achieve a fair presentation. The rule-makers and preparers are allowed to assume that the important users are educated and intelligent.

6.2.4 Elements of financial statements

Chapter 4 of the *Framework* examines the five 'elements' of financial statements. Accounting can work on one of two bases:

Method 1

- *Expenses* of 20X1 are the costs of any period that relate to 20X1; and therefore . . .
- *Assets* at the end of 20X1 are any remaining debits.

Method 2

- *Assets* at the end of 20X1 are controlled resources that are expected to give future benefits; and therefore . . .
- *Expenses* of 20X1 are any remaining debits.

The IASB *Framework* gives primacy to the second way of defining the elements, by starting with an asset defined as follows (paragraph 4.6):

> An asset is a present economic resource controlled by the entity as a result of past events.

This has the effect of reducing the importance of the matching concept, as noted above. If an expense is postponed in order to match it against a future income, it would have to be stored in the balance sheet as an asset. However, this is not allowed under IFRS unless the amount meets the definition of an asset. This restriction on the items to be shown as assets does not come from a desire to be prudent but from a desire to comply with a coherent framework.

The IASB gives similar importance to the definition of 'liability'. According to the *Framework*:

> A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

An obligation is an unavoidable requirement to transfer resources to a third party. Many liabilities are clear legal obligations of exact amounts, such as accounts payable or loans from the bank. Some liabilities are of uncertain timing or amount. These are called 'provisions'. Depending on the nature of legal contracts, some of these provisions are also legally enforceable, such as provisions to pay pensions to retired employees or to repair machinery sold to customers that breaks down soon after sale. Some obligations are not based on precise laws or legal contracts but would probably be enforced by a court of law based on normal business practices or, at least, the enterprise would suffer so much commercial damage if it did not settle the obligation that it cannot reasonably avoid settling it.

'Equity' is the word used for the residual interest in the entity, as calculated by deducting the liabilities from the assets. So, equity is not independently defined. Similarly, as explained above, the definitions of income and expenses derive from those of assets and liabilities:

> Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims.
>
> Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.

However, Barker (2010) has pointed out that these definitions are the wrong way round. That is, an increase in an asset is a *debit*, whereas income is a *credit*. So, income should be defined as an increase in equity resulting from an increase in an asset, and so on. Other comprehensive income (OCI) is not defined as a separate element. However, later, Chapter 7 suggests that profit or loss is a measure of the performance of the year, and that income should be included in it unless it has special features, including being related to the re-measurement of assets or liabilities.

Chapter 5 of the Framework discusses the issue of recognition. Not all items that meet the definitions of asset or liability are recognized. This might be caused by improbability of inflows, high uncertainty of measurement or excessive cost. An important change from the original *Framework* of 1989 is that there is no mention in the definitions of asset or liability that inflows or outflows are 'expected'; and there is no recognition requirement that the flows should be 'probable'. Indeed, despite the old *Framework*, derivative financial instruments are recognized under IAS 39 or IFRS 9 even if no flows are probable. The change in the *Framework* might affect future standard setting, potentially widening recognition.

6.2.5 Measurement

Chapter 6 of the *Framework* deals with the measurement of assets and liabilities. It sets out the different possible measurement bases, principally historical cost or current measures. The latter include fair value and value in use (discounted cash flows). Chapter 6 provides some guidance on how to choose a measurement basis, including consideration of how an item will affect future cash flows.

6.3 Presentation and accounting policies

IAS 1 (*Presentation of Financial Statements*) turns some of the *Framework*'s ideas into requirements. For example, the going concern concept and consistency are dealt with. The overall requirement is for a fair presentation, and this includes the instruction to depart from standards where necessary to achieve such a fair presentation. A similar 'override' is found in the EU Fourth Directive and the resulting national laws (see Chapter 13). It had been widely assumed that the override would not be used in IFRS practice. However, a high-profile use was that by the French bank, Société Générale, in order to show a large loss of 2008 caused by a 'rogue trader' in its 2007 income statement. IAS 1 requires a numerical reconciliation from any basis that departs from any standard to the basis required in that standard. This is examined in more detail by Nobes (2009).

IAS 1 requires an entity to present four financial statements. First, there is the statement of financial position, often called a balance sheet in US or UK practice. In this book, we use the two terms interchangeably. If there have been any restatements (e.g. due to policy changes or error corrections), then an opening balance sheet for the earliest period presented must also be shown. If figures for two years are normally shown (the minimum required by IAS 1), this would mean that three balance sheets would be shown when there had been restatements.

Unlike some national laws (see Chapter 15), IAS 1 does not set out standard formats for financial statements. However, it does give a minimum list of headings to be shown on financial statements. In the balance sheet, a split between current and non-current items is required, unless a presentation in liquidity order without such a split would be more appropriate (e.g. in a financial institution). The term 'current' is defined widely to include both realization within one year or realization within the entity's operating cycle.

IFRS 5 requires an entity to identify separately any formerly non-current assets that are now intended for sale within a year, and to show them on the balance sheet under the heading 'held for sale'. Where a major line of business is to be sold within the coming year or has been sold in the past year, its revenues and expenses should also be separated out and shown as 'discontinued operations' in the statement of comprehensive income. This is designed to help the users to predict the future.

The next requirement in IAS 1 as amended in 2011 (for compulsory effect in 2013) is for a 'statement of profit or loss and other comprehensive income' (SPLOCI). This must include all items of income and expense, including revaluations. There must be no reserve movements; no gains and losses go directly to equity. However, some gains and losses (e.g. some revaluations and some foreign currency gains and losses) have traditionally been treated differently in IFRSs and in all national accounting systems. IAS 1 preserves this idea because these items are shown at the bottom of the SPLOCI as 'other comprehensive income'. The total *excluding* these amounts is shown as the 'profit or loss'. The technical term 'earnings' (see Section 6.7) also excludes these amounts. IAS 1 allows an entity to show a separate 'income statement' section, containing only the elements of profit or loss. Until 2013, most companies had shown profit/loss and OCI as two separate statements, and this has continued.

In this book, we will also sometimes use 'profit or loss' to refer to the parts of income excluding other comprehensive income. The equivalent statement under UK law is, indeed, called a 'profit and loss account'. In the US, the 'income statement' is the equivalent statement, and that term is also often used to mean 'profit or loss' by companies using IFRS. Consequently, this book uses 'income statement' in some chapters.

Unfortunately, there is no clear principle to explain why some gains and losses are 'profit or loss' and some are not. This is discussed further in Chapter 9.

After the SPLOCI, there is a statement of changes in equity (SCE) which shows all changes in equity in the period. These will be of three types:

1 comprehensive income (from the SPLOCI);
2 effects of restatements (i.e. any policy changes or corrections of errors);
3 transactions with owners (e.g. share issues or dividend payments).

Lastly, IAS 7 requires the presentation of a statement of cash flows, which classifies cash flows into operating, investing and financing flows. The total flow then reconciles to the period's change in the total of cash and cash equivalents. Like US GAAP, IAS 7 allows operating cash flows to be calculated either directly or indirectly by adjusting profit for non-cash items such as depreciation.

IAS 8 (*Accounting Policies, Changes in Accounting Estimates and Errors*) deals with the choice of accounting policies and how to account for changes in them. Some standards give companies choices (e.g. measurement at cost or fair value for some assets; see Section 6.4 below). On some topics, there are no instructions in IFRS, so a suitable accounting policy must be created by the company. The *Framework* should be used to help policy choice or creation. IAS 8 requires allows a change of policy to one that gives more relevant information. Nobes and Stadler (2015) study 434 policy changes by companies of ten countries in the period 2006–2011, finding that most

are explained using qualitative characteristics from the *Framework*, particularly increased comparability.

IFRS 1 covers the major example of full-scale change to accounting policies that occurs when an entity first adopts IFRS. Retrospective application of the standards in force at the date of adoption is generally required, but with a number of optional exemptions from the full rigour of that. IAS 8 also covers changes of estimate, such as revising the depreciable life of a machine. These are common, and are absorbed into current and future financial statements without any special disclosure. By contrast, errors must be corrected by adjusting the opening balance sheet rather than through current income.

Taking it further

You can take the issues in this section further in several ways, such as:

- look at the discussion papers and exposure drafts concerning revisions of the conceptual framework (on the IASB or FASB websites);
- see Chapter 7, for examples of how presentation can differ among IFRS reporters;
- see Chapter 8, for differences in presentation and jargon between IFRS and US accounting;
- see Chapter 9, for further discussions on the presentation of comprehensive income;
- see Chapter 15, for the formats of financial statements used in several EU countries.

6.4 Revenue and foreign currency transactions

In IFRS, the term 'revenue' refers to a particular type of income, most obviously sales to customers. This is shown as the first line of the income statement, and is usually the largest number in the whole of the financial statements (other than totals). Unlike some other income (e.g. a gain on selling a non-current asset), revenue is shown gross. It is measured at the fair value of the consideration received from the customer. At its simplest, this is the cash received or promised.

Revenue is recognized when control of goods or services is passed to the customer, typically on delivery. However, there are some circumstances under which revenue is measured over a period. The new standard on revenue, IFRS 15, which was issued in 2014, reduces the use of the 'over time' or percentage-of-completion basis, compared to IASs 11 and 18. Up to, and including, 2017 both sets of standards are in use.

In many companies, whether they operate on a multinational basis or not, transactions are often denominated in foreign currencies. This can include sales, purchases and loans. As examples, a Danish company might sell to American customers

and send them invoices in dollars, or a UK company might buy a computer from a German company and receive an invoice to pay in euros.

According to IAS 21, transactions should be translated into an entity's currency at the rate ruling on the date of the transaction. After that, balances of revenue or of tangible or intangible assets should not be re-stated if exchange rates change. However, resulting monetary balances (foreign receivables and payables) should be translated in subsequent balance sheets at the current rate, with gains and losses taken to profit or loss.

Taking it further

You can take the issues in this section further as follows:

- Chapter 9 examines IFRS 15 in more detail.
- Chapter 17 is an extensive investigation of currency translation.

6.5 Assets

6.5.1 Inventories

IAS 2 deals with most inventories. As under many accounting systems, inventories should be valued at the lower of cost and net realizable value. Cost can be measured using FIFO or weighted average. The former option to use LIFO was removed in 2003 with effect from 2005.

6.5.2 Tangible and intangible non-current assets

Tangible fixed assets are covered by IAS 16 (*Property, Plant and Equipment*) and IAS 40 (*Investment Property*), and most intangible assets are covered by IAS 38 (*Intangible Assets*), although purchased goodwill is dealt with by IFRS 3 (see Section 6.7 and Chapter 16). Biological assets are the subject of IAS 41.

IASs 16, 38, 40 and 41 have similar rules on recognition. An asset should be recognized (capitalized) when it meets the definition of an asset (see Section 6.2), when it will probably entail future benefits and when its cost can be measured reliably. These conditions lead to a ban on the capitalization of internally generated intangibles such as goodwill, research costs, brands, customer lists and so on. Similarly, expenses that do not lead to assets (e.g. formation expenses) must not be capitalized. However, if intangibles are *purchased*, either separately or as part of a business combination, they should be recognized. The exception to the ban on capitalization of internally generated costs is development projects that meet criteria concerning their likely future benefits. Such costs must be capitalized.

Assets should initially be measured at their cost, except for biological assets (see below). IAS 23 requires interest on the construction of assets to be capitalized as part

of the cost. Subsequently, assets can continue to be measured at cost (subject to depreciation and impairment, see below). However, tangible assets can instead be held at current fair value, as long as a whole class (e.g. land, or land and buildings) is measured on the same basis. The standard-setters show their suspicion of intangible assets by only allowing revaluation when there is an active market for an intangible. As this requires homogeneous assets and public prices, most intangibles (such as brands and development costs) cannot be revalued. The valuation (or measurement) of assets is taken further in Chapter 9.

For investment properties measured at fair value, revaluation gains and losses are taken to profit or loss, and no depreciation is charged. For any other assets (under IASs 16 and 38), revalued amounts are treated as replacements for the original cost. So the gains/losses on revaluation go to other comprehensive income, and the calculations of depreciation and the gains/losses on sale are made by reference to the revalued amounts.

If an enterprise receives a government grant related to an asset, then IAS 20 allows the grant to be deducted from the asset's cost or to be shown as deferred income. Either way, the grant is taken to income over the life of the asset, because of reduced depreciation or by gradually reducing the size of the deferred income. Frankly, this makes little sense because, if the cash is in the bank and the entity has no liability (no expected repayment of the grant), then it must have made a gain. At first sight, the spreading of the grant over the life of the asset could be defended by invoking the pre-*Framework* approach of matching. However, even that would not work because the life of the asset can be seen to be irrelevant by considering a grant for the purchase of land, which has no depreciable life. Following IAS 20 would seem to lead to never recognizing income for such a grant. The IASB is aware of this problem and has announced its intention to replace IAS 20.

Most assets should be depreciated over their useful economic lives. In the case of an intangible asset, the life may be difficult to estimate, so IAS 38 requires any intangible assets with indefinite lives to be tested annually for impairment rather than being amortized. Intangible assets are discussed in more detail in Chapter 9.

According to IAS 36, assets should be examined at each balance sheet date to see if there is any indication of impairment (e.g. physical damage). If not, no calculations need to be done, except for intangibles with indefinite lives. However, if there *is* an indication of impairment, calculations of value (recoverable amount) are necessary. If the asset's carrying amount (e.g. depreciated cost) exceeds the recoverable amount, the excess must be removed and charged as an impairment loss. The recoverable amount is measured as the higher of the value in use and net selling price. As management have decided not to sell most non-current assets, this suggests that value in use is generally higher than net selling price, and so would be used as the recoverable amount. Value in use is measured by estimating the discounted cash flows expected from an asset.

Biological assets are measured initially and subsequently at fair value less expected costs to sell, which amounts to a net selling price. Gains/losses are taken to profit or loss. This does not apply to bearer plants (e.g. trees kept to bear fruit), which are treated under IAS 16. At the point of harvest, a biological asset becomes inventory, and the fair value at that point becomes the cost for inventory accounting. The IASC

was able to establish this clear rule for biological assets in IAS 41 (unlike the measurement choices in IASs 16, 38 and 40) partly because most Board delegations were not directly concerned with biological assets, so there was less political opposition to fair value and to taking 'unrealized gains' to profit or loss.

6.5.3 Leases

Leases are divided by IAS 17 into those that transfer substantially all the risks and rewards of the leased asset to the lessee (finance leases) and those that leave them with the lessor (operating leases). The latter are treated, following their legal form, as rentals. However, finance leases must be capitalized as assets and liabilities of the lessee and shown as receivables by the lessor.

There are problems with the 'substantially all' in the above definition. First, this is rather vague. In the US, one reference point for this is 90 per cent of the fair value of the asset. So, for example, a lease involving 92 per cent of fair value would generally lead to full capitalization of the asset and matching liability, whereas a lease involving 88 per cent of fair value would not be capitalized at all. This makes little sense. Related to this is the fact that there is no 'substantially all' in the definitions of asset and liability (see Section 6.2).

The conclusion of the IASB and some other standard-setters (McGregor, 1996) was that lease accounting needed to be reformed. As a result of these concerns, the IASB and FASB jointly published exposure drafts in 2010 which proposed that all uncancellable leases (except some short-term ones) should be treated as finance leases. However, it became clear that removing all leases from lessors' balance sheets did not seem right. Consequently, a new version of the operating/finance split was invented in revised exposure drafts of 2011. The resulting new standards were issued in 2016, with some differences between the IASB and FASB documents. IFRS 16 requires lessees to treat leases as finance leases, except for some short and small leases.

6.5.4 Financial instruments

IAS 32 deals with the definitions and presentation of financial instruments, which include financial assets, financial liabilities and equity. IAS 32 was path-breaking when it was published in 1995 because it requires the classification of liabilities and equity to be based on the substance of the instruments not on their legal form. For example, redeemable preference shares contain a commitment to pay cash to the shareholders, so they must be treated as debt, and the dividends must be treated as interest expenses. This was not the case in the national rules of any major countries at the time, and mostly is still not.

The same point applies to convertible debentures but has the reverse effect. That is, such instruments should be treated as partly equity, with a proportion of the financial payments being re-classified from interest expense to dividends.

IAS 32 originally contained disclosure requirements relating to financial instruments. However, these were expanded and transferred to IFRS 7. The *measurement* of financial instruments has been the most controversial area of standard setting. IAS

39 was the original standard on this topic. It is available throughout the world until at least 2018. However, IFRS 9, which was not issued in a complete version until 2014, replaces it. This is discussed in Chapter 9.

Financial assets are defined very widely to include cash and receivables as well as investments of all types. Investments should (according to IAS 39) be valued at fair value, unless they fall into one of the following categories:

- no reliable fair value (e.g. some unlisted shares);
- those intended to be held to maturity (e.g. some bonds);
- non-traded loans originated by the enterprise (e.g. loans made by banks).

The measurement of these three types of assets (and of financial liabilities) can be based on cost, although IAS 39 allows the option of fair value for the latter two cases under certain conditions.

For the investments valued at fair value, the gains and losses should be recognized in profit or loss, except that those related to investments categorized as 'available for sale' should be put through other comprehensive income. For those financial instruments not measured at fair value in the balance sheet, IFRS 7 requires note disclosures of fair value.

Financial liabilities should be 'marked to market' (i.e. held at fair value with gains and losses to profit or loss) if they are derivatives or for trading. Otherwise, either they can be held at amortized proceeds or some can be marked to market (see Chapter 9 for more detail). The conditions under which hedge accounting is allowed are set out in IAS 39. This complex issue is outlined in Chapter 9.

In 2008, IAS 39 was amended to allow companies, under exceptional circumstances, to avoid showing losses by reclassifying items out of the 'fair value through profit or loss' category. This is discussed in Chapters 9 and 10.

IFRS 13 explains that 'fair value' means the current market price for selling an asset or transferring a liability. IFRS 13 does not explain when to use fair value (other standards, particularly IAS 39 and IFRS 9, do that), but it gives guidance on how to measure it.

Taking it further

You can take the issues in this section further in several ways, such as:

- see Chapter 7, for variations in IFRS practice on asset measurement;
- see Chapter 8, for IFRS/US comparisons, for example on LIFO usage in the United States;
- see Chapter 9, for further discussion of the recognition and measurement of assets under IFRS, and for more on financial instruments;
- see Chapter 10, for the politics surrounding the setting of international standards, especially on financial instruments;
- see Chapter 15, for differences from IFRS requirements in several EU countries.

6.6 Liabilities

The IASB's definition of a liability is set out in Section 6.2.4. Financial instrument liabilities have already been mentioned above. Other liabilities include provisions, employee benefits and deferred tax.

6.6.1 Provisions

Provisions (according to IAS 37) are liabilities of uncertain timing or amount. Let us take the example of provisions for repair expenses. The *debit* side of the double entry for the creation of the liability is an expense. At a year end, it has been traditional practice under German national rules (see Chapter 15) to charge the expected repair expenses of the first three months of the following year. This has a tax advantage in Germany because a (tax-deductible) expense can thereby be charged earlier. The large German chemical company (BASF) provided an example (Annual Report of parent company, 2014):

> Other provisions are recognized … to cover omitted maintenance procedures as of the end of the year, which will be incurred within the first three months of the following year.

The entries to record such a repair provision would be as follows, at the end of 20X1:

- *Debit:* Repair expense of 20X1
- *Credit:* Provision for repair expense (to be carried out in 20X2)

Suppose that the definition of an expense is the traditional one, based on matching, as outlined above (Method 1 in Section 6.2.4), then it would be easy to argue that the German practice is right. That is, the reason for the need for repair of a machine in early 20X2 was the wearing out of the machine in 20X1. So, the expense could be said to *relate* to 20X1.

However, let us now give primacy to the IASB's definition of 'liability'. In the above example of the repair, does the enterprise have an obligation to a third party at the balance sheet date to transfer resources? Probably not. If not, there is no liability at the end of 20X1; therefore, there can be no expense in 20X1; therefore the above entries should not be made.

Returning to IAS 37, when provisions are recognized, they should be measured at the best estimate of the amount that would be required to settle the obligation at the balance sheet date. This includes discounting for the time value of money.

Contingent liabilities are possible liabilities or liabilities that cannot be quantified or are unlikely to lead to outflows of resources. They should be shown in the notes, unless they are remote. Chapter 9 considers further the topics of provisions and reserves.

6.6.2 Employee benefits

IAS 19 covers employee benefits such as bonuses, and post-employment benefits such as pensions. These should be recognized on a balance sheet when they are liabilities that have a probable outflow which is measurable.

The greatest complications occur when an enterprise has made commitments to pay defined benefit payments, such as pensions that depend on length of service and future salary levels. Basically, these must be accounted for as the discounted estimate of the existing obligation at the balance sheet date less the fair value of any fund set up outside the enterprise to pay the obligation.

Another important employee benefit in some companies is share-based payments. IFRS 2 deals with this. If the promised payments to employees are related in size to the company's share price but are to be made in cash, a liability and an expense are recorded over the period that the employee must work in order to earn the payment. If the payment is to be in the company's own shares or share options, the credit is to equity rather than to a liability. This is because a company's own shares are not its resources.

6.6.3 Deferred tax

IAS 12 requires enterprises to account fully at current (or future) enacted tax rates for deferred tax assets and liabilities arising on temporary differences between the carrying values of the enterprise's assets and liabilities and their tax values. This, again, is a complex issue and is examined later (e.g. Sections 8.6 and 9.7).

Taking it further

You can take the issues in this section further in several ways, such as:

- see Chapter 7, for international variations in IFRS practice for pension accounting;
- see Chapter 8, for US comparisons on pension accounting;
- see Chapters 8 and 9, for more detail on deferred tax;
- see Chapter 9, for an extended treatment of pension and other provisions.

6.7 Group accounting

6.7.1 Business combinations

IFRS 3 requires business combinations to be accounted for as acquisitions (also called purchases). It does not allow a method called uniting of interests (called pooling in the US or merger accounting in the UK). On acquisition, the identifiable assets, liabilities and contingent liabilities of the new subsidiary should be brought into the consolidated balance sheet at their fair values. Any excess payment is capitalized as goodwill. IFRS 3 requires annual impairment tests for the goodwill rather than amortization. This is consistent with IAS 38's requirement for intangible assets with indefinite lives. In the unusual event that negative goodwill should arise, it must be treated as income immediately because it is not a liability.

6.7.2 Consolidated statements

IFRS 10 defines a subsidiary as an entity over which an investor has control, i.e. the power to affect the amount of the investor's returns from the entity. This control means that the assets and liabilities of the subsidiary are also those of the group, so they should be fully consolidated. This applies even if the subsidiary is very dissimilar from the rest of the group. Subsidiaries should also be consolidated even if control is temporary, but they will be shown as 'held for sale' under IFRS 5. A parent need not present consolidated statements under certain circumstances, e.g. if (among other things) it is itself a wholly-owned subsidiary.

Normal consolidation procedures (e.g. elimination of inter-company balances) are required. Non-controlling interests must be shown as group equity (because they do not fit the definition of a liability), although not as parent's equity.

In the unconsolidated statements of the parent, the investment in the subsidiary can be shown at cost, using the equity method or as a financial asset under IAS 39 or IFRS 9 (see Section 6.5.4). The same applies to investments in joint ventures or associates (see below).

6.7.3 Joint arrangements

A joint arrangement is evidenced by a contract of joint control that requires the unanimous consent of two or more parties over directing the activities of the arrangement. IFRS 11 deals with the accounting in such a case. There is little problem with joint operations. They can be accounted for according to who controls the relevant assets, and so on. The interesting question is what to do with a joint venture entity. Is this in the venturer's group or not? For consolidated statements, the former IAS 31 allowed a choice of proportional consolidation (see Chapter 16) or the equity method. However, IFRS 11 allows only the equity method. In other words, the venture is treated as a sort of investment, like an associate (see Section 6.7.4 below).

6.7.4 Associates

Associates are defined by IAS 28 as entities over which an investor can exercise significant influence but not control. This vague term is given some precision by reference to a presumption that a holding of 20 per cent or more of voting shares leads to significant influence. Clearly the investor does not control, and should not consolidate, the associate's assets, etc. However, it also seems unsatisfactory to record the holding at cost and take only dividends as group income. The equity method is required by IAS 28 for consolidated statements as a sort of compromise between these extremes.

The equity method brings the investor's proportion of the associate's (or joint venture's) equity (= net assets) and income into the investor's consolidated financial statements. It is not clear whether this is supposed to be a one-line consolidation method or a proxy for showing the value of the investment. The equity method is looked at in more detail in Chapter 16.

The financial statements of any foreign subsidiaries, joint ventures or associates should be translated after identifying their functional currencies. The rules for translation under IAS 21 are of considerable complexity and are examined in detail in Chapter 17.

Taking it further

You can take the issues in this section further in several ways, such as:

- see Chapter 7, for international differences in the treatment of joint arrangements under IFRS;
- see Chapter 8, for US comparisons and more detail on types of business combination;
- see Chapter 16, for an extended treatment of group accounting issues;
- see Chapter 17, for an extended treatment of foreign currency translation.

6.8 Disclosures, and management commentary

Each of the standards looked at above contains disclosure requirements, generally grouped together at the end of a standard. However, there are other standards that are solely about disclosures and do not affect the recognition of assets, liabilities, equity, income or expenses. Two important disclosure standards are summarized below. These two are only compulsory for enterprises whose securities are publicly traded.

1. IFRS 8 requires reporting of many items (e.g. assets, sales and profit) split into the segments as reported to an entity's chief operating officer. This is designed to help users of financial statements to predict cash flows by splitting this year's and last year's performance and assets into segments of similar items.
2. IAS 33 requires disclosure of the enterprise's basic earnings per share (EPS). The earnings is the net profit after tax and preference dividends. The 'per share' number is the weighted average of the ordinary shares outstanding during the period. It is also necessary to disclose the diluted EPS by adjusting the earnings and the shares for any possible extra shares (e.g. convertible debentures) that would make the EPS look worse.

In 2010, the IASB issued a 'practice statement' on the subject of 'management commentary'. A practice statement is guidance rather than being a mandatory standard. A management commentary is referred to by other names in the US (Management's Discussion and Analysis) or in the UK (Operating and Financial Review).

The IASB's practice statement gives guidance on the purpose, principles and presentation of a management commentary, and suggests that it should contain information about the company on the following issues:

- nature of business;
- objectives and strategies;
- resources, risks and relationships;
- results and prospects;
- performance measures and indicators.

Taking it further

You can take the issues in this section further in several ways, such as:

- see Chapter 5, for a discussion of interpreting financial statements and disclosures in an international context;
- see Chapter 18, for an extended treatment of segment reporting;

6.9 Synthesis: the sources of the content of IFRS

Now that the main content of IFRS has been examined, we can ask a further question: where did it come from? In the case of some *options*, a national source is clear. For example, the former option to use proportional consolidation to account for joint ventures (see 6.7.3) came from French law. However, let us now concentrate on the *requirements* of IFRS that were current in 2016. In some cases, IFRS followed what was widespread practice around the world, e.g. requiring depreciation of PPE. In some instances, the widespread practice can itself be traced to particular countries, e.g. consolidation had been invented in the United States 70 years before the creation of the IASC. However, on many topics, a particular country is a clear contemporary source of a development in international standards. Table 6.2 shows several such cases.

Many of the sources identified in Table 6.2 are parts of US GAAP. These include major reporting practices such as the basis for deferred tax, the capitalization of leases and marking-to-market for many financial instruments. However, there are also many features of IFRS that are clearly different from US GAAP. Mostly, the source of these is UK GAAP. All but two of these UK-sourced features were not found in other parts of Europe. The first exception to that is the 'override' in IAS 1 (see Section 6.3), but that had spread to the rest of the EU from the UK via the Fourth Directive (see Chapter 13). The second exception is optional revaluation of PPE, which can also be seen in Dutch practice before the creation of the IASC (Zeff *et al.*, 1992).

Some commentators (e.g. Cairns, 1997) have objected to the widely-held view that the content of IFRS is mostly 'Anglo-Saxon'. We sympathize with that view, in the sense that the UK and the US had only two votes among many on the IASC Board. However, it is hard to deny that the ethos of the IASC and the IASB are 'Anglo-Saxon': private-sector and investor-oriented. Further, Table 6.2 suggests heavy UK/US influence on content. Apart from the last item of Table 6.2, the authors are not aware of any major content of IFRS which has an identifiable source that is neither UK GAAP nor US GAAP.

Readers might wonder why the UK, in particular, seems to have been such a major source of the content of IFRS. One explanation is that UK GAAP was easier to understand and apply than US GAAP. Further, many of the senior staff of the IASC and the IASB were British (Camfferman and Zeff, 2007).

Table 6.2 National sources of some main IFRS requirements

Standard	*Requirement*	*Source*
IAS 1	Fair 'override'	UK, Companies Act 1947
IAS 1	Second income statement (now OCI)	UK, FRS 3
IAS 7	Cash flow statements	US, SFAS 95
IAS 8	Accounting for policy changes retrospectively	UK, FRS 3
IAS 12	Deferred tax based on temporary differences	US, SFAS 109
IAS 16	Option to revalue PPE	Netherlands and UK practice
IAS 17	Capitalization of finance leases	US, SFAS 13
IAS 19	Actuarial gains and losses to OCI	UK, FRS 17
IAS 23	Capitalization of interest on construction	US, SFAS 34
IAS 36	Impairment based on recoverable amount, with reversals required	UK, FRS 11
IAS 37	Discounting of provisions	UK, FRS 12
IAS 38	Development costs capitalized when meeting certain criteria	Canada
IAS 38/IFRS 3	Impairment-only for indefinite-lived intangibles	US, SFAS 142
IAS 39/IFRS 9	Marking-to-market for trading and derivative financial instruments	US, SFAS 115/133
IAS 40	Accounting for investment properties separately from PPE	UK, SSAP 19
IAS 41	Biological assets at fair value	Australia
IFRS 5	Treatment of held-for-sale assets	US, SFAS 144
IFRS 7	Disclosures about fair value of financial instruments	US, SFAS 107
IFRS 8	Segment reporting on basis of internal reporting	US, SFAS 131
IFRS 10	Consolidation based on control	Germany, *Aktiengesetz* 1965

SUMMARY

- The IASB's *Framework* was based on the US *Framework*. It is oriented towards investor decision-making. Fair presentation is required and this means trying to maximize the relevance and representational faithfulness of information.
- The *Framework* gives primacy to assets and liabilities, leaving equity, revenues and expenses as derivative terms.
- IAS 1 requires a statement of comprehensive income and a statement of changes in equity.
- Most non-current assets can be revalued under IASB's rules but there is a mixture of measurement bases and presentations of re-measurement gains and losses. There has been a slow move towards the use of fair values, with immediate recognition of profit or loss.
- The IASB's definition of a provision is narrow compared to the meaning under some domestic laws. Provisions should be discounted, and this includes employee benefit obligations.
- Business combinations give rise to goodwill which has to be capitalized. The traditional requirement to amortize has been replaced by annual impairment measurements.
- IFRSs require a number of disclosures, including segment reporting and earnings per share.

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Further reading

For the full text of the IASB's standards, see the annual 'bound volume' from the IASB. For differences between IFRSs and the requirements in various countries, see chapters of Parts II, III and IV of this book.

Useful websites

International Accounting Standards Board	www.ifrs.org
IAS plus (Deloitte)	www.iasplus.com
KPMG	www.kpmgifrg.com
PricewaterhouseCoopers	www.pwc.com/ifrs
Wiley IFRS	www.ifrs.wiley.com

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

6.1* Explain the purposes and uses of a conceptual framework.

6.2* 'Neutrality is about freedom from bias. Prudence is a bias. It is not possible to embrace both conventions in one coherent framework.' Discuss.

6.3 'Substance over form is a recipe for failing to achieve comparability between financial statements of different enterprises.' Discuss.

6.4 Explain why it is necessary to define either 'asset' or 'expense' from first principles, but not both. Why has the IASB chosen to define the former?

6.5 Is it necessary and useful to have different valuation bases for different assets?

6.6 Outline all the ways that one could in principle include a joint venture in a venturer's financial statements. Which is the best?

6.7 'In recent years, the IASB has clearly been moving towards the use of current values rather than historical costs.' Discuss.

Appendix 6.1 An outline of the content of International Financial Reporting Standards

This appendix summarizes the content of IFRSs extant on 1 November 2015.

IAS 1 Presentation of financial statements

This standard was completely revised in 1997 and superseded the old IAS 1, IAS 5 and IAS 13. It was revised again in 2003, 2004, 2007 and 2011. The components of financial statements are a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of cash flows, and notes (paragraph 10). If there have been any restatements, a statement of financial position at the beginning of the earliest comparative period must also be presented. Fair presentation is required and this may sometimes entail departure from an IFRS, which must then be disclosed including the numerical effect (paragraphs 15–24).

The going concern assumption must be assessed for each set of financial statements, and departed from (with disclosure) when appropriate (paragraph 25). Offsetting is only allowed when specifically permitted by another standard (paragraph 32). Comparative information must be given relating to the previous period (paragraph 38).

The current/non-current distinction is generally required (paragraph 60). There are no required formats but there are lists of minimum contents of financial statements (paragraphs 54 and 82). There are also illustrations of formats in an appendix.

IAS 2 Inventories

Inventories should be valued at the lower of cost and net realizable value (paragraph 9). Cost includes all costs to bring the inventories to their present condition and location (paragraph 10). FIFO or weighted average is allowed where specific identification of cost is not appropriate (paragraph 25).

IAS 3

Replaced by IAS 27, then by IFRS 10.

IAS 4

Withdrawn, because the content (on depreciation) is covered by asset standards (particularly IAS 16 and IAS 38).

IAS 5

Replaced by IAS 1 (revised).

IAS 6

Replaced by IAS 15.

IAS 7 Statement of cash flows

Cash flow statements are required (paragraph 1). They should classify cash flows into operating, investing and financial activities (paragraph 10). Cash and cash equivalents include short-term investments subject to insignificant risk of changes in value (paragraph 6).

Either the direct or indirect method of calculating operating flows is allowed (paragraph 18). There is flexibility about where to show flows of interest and dividends (paragraph 31). Cash flows from taxes should be disclosed separately within one of the three headings (paragraph 35).

IAS 8 Accounting policies, changes in accounting estimates and errors

In the absence of a requirement in IFRSs, a policy should be created by analogy and by using the *Framework* (paragraph 11). Changes in policy that result from changes to IFRSs should follow the specific transitional provisions. Voluntary changes are allowed if the resulting information is more relevant; they should be applied retrospectively, by adjusting the earliest presented opening balance of retained earnings (paragraph 19). Changes in estimates should be absorbed in income (paragraph 36). Errors should be corrected retrospectively (paragraph 42).

IAS 9

Replaced by IAS 38.

IAS 10 Events after the reporting period

Events occurring after the reporting period which provide additional information on conditions existing at the balance sheet date should lead to adjustment of the financial statements (paragraph 8). However, disclosure should be made for other events, if necessary for proper evaluation (paragraph 21). Proposed dividends should not be accrued (paragraph 12).

IAS 11 Construction contracts

There is no reference to the length of a contract in its definition, but there is a requirement that the contract should be specifically negotiated (paragraph 3).

When the outcome of such a contract can be estimated reliably, revenues and costs should be estimated by stage of completion. Expected losses should be recognized (paragraph 22). The conditions for reliable estimation are (paragraph 23):

a. revenue can be reliably measured;
b. it is probable that the benefits will flow to the enterprise;
c. future costs and stage of completion can be measured reliably; and
d. costs can be identified and measured reliably.

If the outcome cannot be measured reliably, costs should be expensed and revenues should be recognized in line with costs recoverable (paragraph 32).

This standard is replaced by IFRS 15 for 2017 onwards.

IAS 12 Income taxes

Temporary differences are differences between the carrying amount of an asset or liability and its tax base (paragraph 5). Deferred tax assets and liabilities should be recognized for temporary differences except when relating to goodwill (unless the amortization is tax deductible) or certain transactions with no effect on tax or accounting profit (paragraphs 15 and 24). Deferred tax assets should not be accounted for unless sufficient future taxable income is probable (paragraphs 24 and 34). Certain deferred tax assets and liabilities relating to group companies should be recognized where the temporary differences will reverse (paragraphs 39 and 44).

Current and deferred tax assets and liabilities should use enacted or substantially enacted tax rates (paragraphs 46 and 47). Deferred tax assets and liabilities should not be discounted (paragraph 53). Current and deferred taxes should be recognized in profit or loss to the extent that they relate to transactions not recognized in profit or loss (paragraph 58).

IAS 13

Replaced by IAS 1 (revised).

IAS 14

Replaced by IFRS 8.

IAS 15

Withdrawn.

IAS 16 Property, plant and equipment

Property, plant and equipment (PPE) should be recognized when (a) it is probable that future benefits will flow from it, and (b) its cost can be measured reliably (paragraph 7).

Initial measurement should be at cost (paragraph 15). Subsequently, one treatment is to use cost but an alternative is to use an up-to-date fair value by class of assets (paragraphs 29, 30 and 36). Revaluations should be credited to other comprehensive income unless reversing a previous charge to profit or loss. Decreases in valuation should be charged to profit or loss unless reversing a previous credit to OCI (paragraphs 39 and 40).

Gains or losses on retirement or disposal of an asset should be calculated by reference to the carrying amount (paragraph 68).

IAS 17 Leases

Finance leases are those which transfer substantially all risks and rewards to the lessee (paragraph 3). Finance leases should be capitalized by lessees at the lower of the fair value and the present value of the minimum lease payments (paragraph 12).

Rental payments should be split into: (i) a reduction of liability; and (ii) a finance charge designed to reduce in line with the liability (paragraph 17). Depreciation on leased assets should be calculated using useful life, unless there is no reasonable certainty of eventual ownership. In this latter case, the shorter of useful life and lease term should be used (paragraph 19).

Operating leases should be expensed on a systematic basis (paragraph 25).

For lessors, finance leases should be recorded as receivables (paragraph 28). Lease income should be recognized on the basis of a constant periodic rate of return (paragraph 30). The net investment method should be used (paragraph 30).

For sale and leaseback which results in a finance lease, any excess of proceeds over carrying amount should be deferred and amortized over the lease term (paragraph 57).

This standard is being replaced by IFRS 16.

IAS 18 Revenue

Revenue should be measured at fair value of consideration received or receivable (paragraph 9). Revenue should be recognized when (paragraph 4):

(a) significant risks and rewards are transferred to the buyer;

(b) managerial involvement and control have passed;

(c) revenue can be measured reliably;

(d) it is probable that benefits will flow to the enterprise; and

(e) costs of the transaction can be measured reliably.

For services, similar conditions apply by stage of completion when the outcome can be estimated reliably (paragraph 20).

This standard is replaced by IFRS 15 for 2017 onwards.

IAS 19 Employee benefits

For defined contribution plans, the contributions of a period should be recognized as expenses (paragraph 51).

For defined benefit plans, the liability should be the total of the present value of the obligation minus the fair value of plan assets (paragraph 57). The profit or loss charge should be the total of current service costs, interest cost, past service cost and the effect of settlements (paragraph 57).

The actuarial valuation method is specified (i.e. the projected unit credit method) (paragraph 67). The discount rate used should be based on the market yield on high-quality corporate bonds (paragraph 83).

Remeasurements are charged to other comprehensive income. These include actuarial gains and losses and return on plan assets (paragraphs 128 to 130).

IAS 20 Government grants

Grants should not be credited directly to reserves but should be recognized as income in a way matched with the related costs (paragraphs 7 and 12). Grants related to assets should be deducted from the cost or treated as deferred income (paragraph 24).

IAS 21 The effects of changes in foreign exchange rates

Transactions should be translated on the date of the transaction (paragraph 21). Subsequently, monetary balances should be translated at the closing rate, and non-monetary balances at the rate which relates to the valuation basis (e.g. historical cost) (paragraph 23). Differences on monetary items should be taken to profit or loss, unless the items amount to a net investment in a foreign entity (paragraphs 28 and 32).

Financial statements of other entities whose functional currency is not the presentation currency should be translated using closing rates for balance sheets and transaction rates (or, in practice, average rates) for incomes and expenses. Differences should be taken to other comprehensive income (paragraph 39).

IAS 22 Business combinations

Replaced by IFRS 3.

IAS 23 Borrowing costs

Borrowing costs on construction projects must be capitalized as part of the cost of the asset (paragraph 8). Where funds are specifically borrowed, the borrowing costs should be calculated after any investment income on temporary investment of the borrowings (paragraph 12). If funds are borrowed generally, then a capitalization rate should be used based on the weighted average of borrowing costs for general borrowings outstanding during the period. Borrowing costs capitalized should not exceed those incurred (paragraph 14).

Capitalization should commence when expenditures and borrowing costs are being incurred and activities are in progress to prepare the asset for use or sale (paragraph 17). Suspension should occur when active development is suspended for extended periods, and cessation should occur when substantially all activities are complete (paragraphs 20 and 22).

IAS 24 Related party disclosures

Related parties are those able to control or exercise significant influence, though some exceptions are noted (paragraphs 9 and 11). Relationships and transactions should be disclosed (paragraphs 12 and 17).

IAS 25

Replaced by IAS 39 and IAS 40.

IAS 26 Reporting by retirement benefit plans

This standard relates to accounting and reporting by retirement benefit plans themselves, not by employers. Separate rules are set out for defined benefit plans and defined contribution plans.

IAS 27 Separate financial statements

This standard used to cover consolidated statements as well, but those are now dealt with by IFRS 10. IAS 27 now deals only with the unconsolidated statements of entities that have investments in subsidiaries, joint ventures or associates (paragraph 10). These should be shown at cost or under IAS 39 or IFRS 9 (i.e. generally treating them as financial assets at fair value).

IAS 28 Investments in associates and joint ventures

An associate is an entity over which the investor has significant influence, i.e. the power to participate in financial and operating policy decisions (paragraph 3). This is

a rebuttable presumption when there is a holding of 20 per cent or more in the voting rights (paragraph 5).

Associates and joint ventures should be accounted for by the equity method in consolidated statements, even when held for disposal in the near future (paragraphs 16 and 20).

IAS 29 Financial reporting in hyperinflationary economies

Hyperinflation is indicated by several features, including cumulative inflation over three years of 100 per cent or more (paragraph 3).

Financial statements (including corresponding figures) should be presented in a measuring unit which is current at the balance sheet date (paragraph 8).

IAS 30 Disclosures by banks

Replaced by IFRS 7.

IAS 31 Interests in joint ventures

Replaced by IFRS 11.

IAS 32 Financial instruments: presentation

Financial instruments should be classified by issuers into liabilities and equity, which includes splitting compound instruments into these components (paragraphs 16 and 28).

Treasury shares (i.e. a company's own shares that have been bought back by the company) must be shown as a deduction from equity (paragraph 33).

Financial assets and liabilities can be set off when there is a legally enforceable right and an intention to do so (paragraph 42).

IAS 33 Earnings per share

The standard applies to entities with publicly traded shares (paragraph 2).

Basic EPS should be calculated using (i) the net profit or loss attributable to ordinary shareholders, and (ii) the weighted average ordinary shares outstanding in the period (paragraph 10). The weighted average should be adjusted for all periods presented for events (e.g. bonus issues) that change the number of shares but not the resources (paragraph 19).

Diluted EPS should adjust earnings and shares for all dilutive potential ordinary shares (paragraph 30). Presentation of basic and diluted EPS should be on the face of the income statement (paragraph 47).

IAS 34 Interim financial reporting

This standard is not mandatory but might be imposed by stock exchange authorities, for example (paragraph 1).

The minimum contents of an interim report should be condensed comprehensive income statement, balance sheet, changes in equity, cash flow and notes (paragraph 8). Minimum contents of the statements and the notes are specified (paragraphs 10 and 16). Prior period data should be presented (paragraph 20).

The frequency of reporting should not affect the annual results (paragraph 28). In most ways, the end of a period should be treated as the end of a year (paragraphs 28, 37, and 39).

IAS 35 Discontinuing operations

Replaced by IFRS 5.

IAS 36 Impairment of assets

Entities are required to check at each balance sheet date whether there are any indications of impairment; several examples are given (paragraphs 10 and 12). When there is an indication of impairment, an entity should calculate the asset's recoverable amount, which is the larger of its net selling price and value in use. The latter is equivalent to the discounted expected net cash inflows, which should be calculated for the smallest group of assets (cash generating unit) for which the calculation is practicable (paragraphs 30 and 66). Goodwill and other intangibles with indefinite lives must be tested for impairment annually.

If the asset's recoverable amount is less than its carrying value, an impairment loss must be recognized (paragraph 59). Impairment losses should first be allocated to goodwill (paragraph 104). Impairment losses, except those relating to goodwill, should be reversed under certain circumstances (paragraph 110).

IAS 37 Provisions, contingent liabilities and contingent assets

A provision is defined as a liability of uncertain timing or amount. For there to be a liability, there must be an obligation at the balance sheet date (paragraph 10). Provisions should be recognized unless a reliable estimate cannot be made or the outflow is not probable (paragraph 14).

Contingent liabilities (where there is no obligation or where there is no reliable measure or no probability of outflow) should not be recognized as liabilities but disclosed in the notes, unless remote (paragraphs 10, 27, 28). Contingent assets should not be recognized (paragraph 31).

IAS 38 Intangible assets

Intangible assets should be recognized where it is probable that benefits will flow to the enterprise and cost can be measured reliably (paragraph 21).

Internally generated goodwill must not be capitalized (paragraph 48). Research and many other internally generated intangibles cannot meet the above recognition criteria (paragraphs 54 and 68). Development expenditure may sometimes meet the criteria, and must then be capitalized. More detailed guidance is given on this (paragraph 57). Costs treated as expenses cannot subsequently be capitalized (paragraph 71).

Intangible assets for which there is an active market can be carried at fair value (paragraph 75).

Intangible assets with finite useful lives should be amortized (paragraph 97). Annual impairment tests are otherwise required (paragraph 107).

IAS 39 Financial instruments: recognition and measurement

IAS 39 is being replaced by IFRS 9. However, that standard does not come compulsorily into force until 2018 or later. So, many companies are still applying IAS 39.

All financial assets and financial liabilities, including derivatives, should be recognized on the balance sheet (paragraphs 2 and 14). Financial assets should be held at fair value except that the following are held at amortized cost:

(a) receivables originated by the enterprise and not held for trading,

(b) held-to-maturity investments, and

(c) assets whose fair value cannot be measured reliably (paragraph 46).

However, an option allows some assets of type (a) or (b) to be held at fair value.

Financial liabilities are held at amortized proceeds, except that fair value should be used for those held for trading and for derivatives, and that option exists for some others (paragraph 47).

Gains and losses should be recognized in profit or loss, except that gains on available for sale items are taken to other comprehensive income (paragraphs 55 and 56).

Hedge accounting is permitted under certain circumstances for derivatives and (only for foreign currency risks) for other financial instruments. The hedges must be designated and effective (paragraph 88).

IAS 40 Investment property

Investment property is held to earn rentals or for capital appreciation, rather than being inventory or being owner-occupied (paragraph 5).

Initial measurement should be at cost, and there should be subsequent capitalization of expenditure that improves the originally assessed standard of performance (paragraphs 16 and 20). There should then be an entity-wide choice of the fair value model or the cost model (paragraph 30). Under the first of these, gains and losses are taken to profit or loss (paragraph 35). If, under the fair value model, fair value of a particular property is not determinable at the beginning, then cost should be used (paragraph 53).

Transfers to owner-occupied property or inventory should take place at fair value (paragraph 60). Transfers to investment property should treat the initial change to fair value as a revaluation under IAS 16 (paragraph 61).

Under the cost model, fair value should be disclosed (paragraph 79).

IAS 41 Agriculture

This standard covers all biological assets to the point of harvest (paragraph 1). Such assets are measured at fair value less costs to sell (paragraph 12), except that bearer plants are treated as in IAS 16. If fair value is not reliably determinable, then cost should be used (paragraph 30).

Agricultural produce is measured at harvest at fair value less costs to sell, which then becomes the cost for inventory accounting (paragraph 13).

Gains and losses on changes in fair value should be taken to profit or loss (paragraphs 26 and 28). Government grants should be taken to profit or loss when their conditions are met (paragraph 34).

IFRS 1 First-time adoption of International Financial Reporting Standards

This standard relates to entities that, for the first time, give an explicit and unreserved statement of compliance with IFRS (paragraph 3). An entity has to prepare an opening

balance sheet for the earliest period presented that is in accordance with the standards ruling at the reporting date (paragraph 6). No other versions of standards are relevant, nor are the transitional provisions of standards. A few retrospective estimates and other adjustments are not allowed, e.g. related to hedge accounting (paragraph 13). A few exemptions are allowed, e.g. for business combinations (paragraph 18).

Reconciliations are required from accounting under the old rules to IFRS (paragraph 24).

IFRS 2 Share-based payment

Share-based payments should be recognized as an expense unless an asset is recognized. The payments can be settled in cash or in shares. The former give rise to liabilities; the latter to equity. The recognition should take place as the goods or services are received (paragraph 7). Share-settled payments should be recognized at fair value: of the goods or services (for non-employees) or of the equity (for employees) (paragraph 10).

No adjustment should be made if shares or share options are forfeited or not exercised after vesting date (paragraph 23).

IFRS 3 Business combinations

All business combinations should be treated as purchases (paragraph 4). Goodwill is the difference between the fair value of the consideration given and the fair value of the subsidiary's assets, liabilities and contingent liabilities (paragraph 32). The resulting contingent liabilities should continue to be recognized despite IAS 37 (paragraph 23). The costs of acquisitions should be treated as expenses. Negative goodwill should be recognized as income immediately (paragraph 34).

IFRS 4 Insurance contracts

This standard applies to insurance contracts, whatever sort of company holds them (paragraph 2).

Insurers are temporarily exempted from the general requirements of IAS 8 on accounting policies. This is pending a full standard on insurance contracts (paragraph 13). Changes to policies are only allowed if the resulting information is more relevant (paragraph 22). A liability adequacy test is required (paragraph 15).

IFRS 5 Non-current assets held for sale and discontinued operations

Non-current assets should be classified as held for sale if expected to be sold within one year (paragraphs 6–8). They should be shown separately on the balance sheet at the lower of carrying value and fair value less costs to sell (paragraph 15).

A discontinued operation is a separate major line of business that has been disposed of or is classified as held for sale (paragraph 32). The statement of comprehensive income should show a single amount for all items related to discontinued operations (paragraph 33).

IFRS 6 Exploration for and evaluation of mineral resources

Pending a full standard on this subject, entities are exempted from certain requirements of IAS 8 on accounting policies (paragraph 7). Measurement of assets should follow IAS 16 (paragraph 12).

A special rule on impairment applies, which allows cash generating units to be as large as, but not larger than, a segment (paragraph 21).

IFRS 7 Financial instruments: disclosures

All types of entities are required to make disclosures about financial instruments on a wide range of issues, including: fair values (paragraph 25), credit risk (paragraph 36), liquidity risk (paragraph 39) and market risk (paragraph 40).

IFRS 8 Operating segments

The standard applies to listed companies (paragraph 2). Operating segments are those regularly reviewed by the entity's chief operating officer (paragraph 5). Information on operating segments should be reported when it is 10 per cent or more of all segments (paragraph 13). Many items must be reported, including revenues, assets, interest, depreciation, tax (paragraph 23). Revenues and non-current assets should be reported by geographical segments (paragraph 33).

IFRS 9 Financial instruments

IFRS 9 is in the process of replacing IAS 39. The 2010 version of IFRS 9 dealt with most aspects of recognition, derecognition, classification and measurement of financial assets and liabilities. A full version of IFRS 9 was published in 2014, but does not come compulsorily into force until 2018.

Financial assets should be derecognized when contractual rights to cash flows expire or when the rights are transferred (paragraphs 3.2.3 and 3.2.4). Financial liabilities should be derecognized when extinguished (discharged, cancelled or expired) (paragraph 3.3.1).

Financial assets should be measured at amortized cost if both (a) the business model is to collect contractual cash flows, and (b) the contractual terms lead solely to payments of principal and interest (paragraph 4.1.2). Other assets should be measured at fair value (paragraph 4.1.4), but for some of them the gains/losses go to OCI (paragraph 4.1.2A). Assets normally measured at amortized cost can be designated (initially and irrevocably) at fair value under some circumstances (paragraph 4.1.5). Liabilities are mostly held at amortized cost, except for derivatives and a few others (paragraph 4.2.1). Certain embedded derivatives must be split out and held at fair value (paragraph 4.3.3).

Re-classification is not allowed for liabilities but is allowed for assets when the business model changes (paragraphs 4.4.1 and 4.4.2).

Impairment of loans and receivables must use an expected credit loss approach (Chapter 5). Rather complex rules relating to hedge accounting are set out in Chapter 6. IFRS 9 contains a very lengthy and detailed appendix containing 'application guidance'.

IFRS 10 Consolidated financial statements

Subsidiaries are entities controlled by an investor (paragraph 2). Control means power to direct the activities of the investee so as to affect the returns coming to the investor (paragraph 7). The power comes from rights (e.g. the majority of voting rights).

Unlisted parents are exempted from preparing consolidated statements if they are themselves wholly-owned subsidiaries (or in some cases partially-owned subsidiaries),

as long as the ultimate parent publishes IFRS statements (paragraph 4). Investment entities should measure their investments which would otherwise be consolidated using fair value through profit or loss (paragraph 31).

When preparing consolidated statements, uniform accounting policies should be used (paragraph 19). Non-controlling interests should be shown in equity but separately from parent's equity (paragraph 22).

IFRS 11 Joint arrangements

Joint arrangements come in two types: joint operations and joint ventures (paragraph 14). In either case, the arrangement is jointly controlled by two or more parties through a contract that requires the unanimous consent of the parties over the direction of the activities that affect the returns of the arrangement (paragraph 7).

Joint operations are included in consolidated or unconsolidated statements by bringing the assets, liabilities, etc. into the appropriate parties' statements. Joint ventures (e.g. companies in which the venturers own all the shares between them) are included in the consolidated statements of the venturers by using the equity method under IAS 28 (paragraph 24). In unconsolidated statements, they are included (under IAS 27) at cost or as financial assets under IAS 39 or IFRS 9 (paragraph 26).

IFRS 12 Disclosure of interests in other entities

This standard requires disclosures about interests in subsidiaries, joint ventures, associates and other 'structured entities' (paragraph 2). The information disclosed should enable users of the consolidated statements to understand, among other things, the composition of the group and the restrictions and risks associated with it (paragraph 10).

IFRS 13 Fair value measurement

This standard does not affect when fair value should be used (paragraph 5). It defines fair value as an 'exit price': a current market price for selling an asset or transferring a liability (paragraph 9). The fair value assumes current market conditions, an orderly market and the principal market used by the entity (paragraphs 11, 15, 16). The fair value is not adjusted for transaction costs (paragraph 25). A hierarchy of three levels of evidence for fair value is provided, starting with quoted prices in active market for an identical asset (paragraph 76).

IFRS 14 Regulatory deferral accounts

This standard deals with certain quasi-assets of companies whose pricing is subject to governmental regulation. Pending a full standard on this subject, entities are exempted from certain requirements of IAS 8 on accounting policies (paragraph 7).

IFRS 15 Revenue from contracts with customers

This standard is replacing IASs 11 and 18. It comes into force compulsorily for 2018.

Entities should identify all the separate performance obligations within their contracts with customers (paragraph 27). Revenue is recognized when a performance obligation is satisfied by transferring an asset (i.e. control) to the customer (paragraph 31). Sometimes this happens at a point in time, e.g. delivery of goods (paragraph 38).

Sometimes it happens over a period, when one of three conditions are met (paragraph 35).

Revenue is measured at the amount of the transaction price related to the performance obligation (paragraph 47). This includes non-cash consideration at fair value and any variable consideration (paragraphs 50 and 66).

The costs of fulfilling a contract should be recognized as an asset if they are recoverable (paragraph 91).

IFRS 16 Leases

This standard is replacing IAS 17. It comes into force for 2019 onwards. It had not been published in November 2015 when the proofs of this book were being read. However, the IASB had announced that IFRS 16 requires lessees to treat all leases as finance leases, except for certain short-term or low value leases.

7 Different versions of IFRS practice

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OBJECTIVES

After reading this chapter, you should be able to:

- explain how the potential reasons for international accounting differences, as discussed in previous chapters, might still be relevant under IFRS;
- give examples of how different versions (including different translations) of IFRS can be in force at the same time;
- give examples of how gaps, choices and estimations in IFRS can lead to varied practices;
- outline how international differences in monitoring and enforcement can lead to varied IFRS practices;
- give examples of actual variety in IFRS practice, and of changes in practice over time;
- discuss some of the implications of the existence of different national versions of IFRS practice.

7.1 Introduction

The objectives of the IFRS Foundation include the development of 'a single set of high quality, understandable and enforceable global accounting standards' and 'to promote the use and rigorous application' of them. Progress continues to be made on this, as the standards become tighter, as compulsory application spreads, and as enforcement becomes more rigorous. However, even if we concentrate on those financial statements that claim to comply with international standards (IFRS), is there uniform practice?

This chapter first examines the motivations for varied practice within IFRS use (Section 7.2). In particular, are there reasons why IFRS might be applied systematically differently from one country to another? Section 7.3 then looks at the scope for IFRS practice to vary. Included in this examination is a look at the overt and covert options contained in IFRS. Study of this will help readers to understand IFRS, not just for the specific purpose of this chapter. It will also reveal the scope for different IFRS practice between companies or between industries, not just between countries.

Section 7.4 looks at some examples of differing IFRS practice between several major countries. Section 7.5 examines changes over time in IFRS practices. Section 7.6 looks at the implications of the existence of different national versions of IFRS practice.

7.2 Motivations for varied IFRS practice

Assuming that there is scope for varied practice within IFRS (see Section 7.3), there are several types of motivation for the scope to be used at the level of companies, industries or countries.

Companies face different circumstances, so might make different policy choices (e.g. Watts and Zimmerman, 1978). For example, some companies might like to show high profits in order to impress the stock market. Others might like to show low profits in order to bolster an argument for raising prices or for reducing dividends or wages. These different motivations can also apply between industries. For example, it is normal in public utilities, such as gas or telecommunications, to have regulated prices and therefore to sometimes want to show low profits as part of making a case for raising prices, but this is not normal in most industries.

This chapter focuses on why companies in certain countries might want to practice IFRS differently from those in other countries. The starting point is to ask whether the causal factors identified in Chapter 2 are relevant. Three factors in particular are considered here: financing systems, tax systems and legal systems. Germany and the UK will be used as the main illustrations because they are important countries (as Europe's two largest economies and stock markets) with clearly contrasting accounting (see Chapter 3).

As discussed in Section 2.4, it is possible to divide countries into 'insider financing' and 'outsider financing', although the starkness of the divide is reducing. For example, Germany was traditionally seen as an 'insider' country, but from the middle of the 1990s the largest German listed companies were already adapting to a shareholder/

outsider financial culture and voluntarily using IFRS or US GAAP (Weissenberger *et al.*, 2004). However, many German listed companies waited to use IFRS until driven by compulsion from the Deutsche Börse and then the EU Regulation 1606 of 2002. Such smaller German listed companies might still be dominated by 'insider' finance and might still feel no commercial need for the creative accounting and extensive disclosures seen in US or UK markets. They might therefore have motivations towards a particular style of IFRS reporting, assuming that opportunities for different styles exist.

Secondly, as discussed in Section 2.3, the literature also divides the *legal* systems of the developed world into two main types: Roman (code) law and common law (e.g. David and Brierley, 1985). This affects the regulation of financial reporting. For example, the preparation of financial statements under German national rules is largely specified by the commercial code (HGB) and tax law, whereas the detail in UK national rules is found in accounting standards written in the private sector. Of course, for IFRS reporting in Germany and the UK, the content of the standards is now the same. However, monitoring and enforcement remain national. This includes the nature and regulation of audit, the stock exchange rules, the activities of the stock exchange regulator and of any other monitoring or review bodies. International differences in these areas continue, so the Roman/common law dichotomy could still affect financial reporting practice. Section 7.3 suggests examples.

The third issue is the influence of tax on financial reporting. This was examined in Section 2.5, where the influence in Germany was seen as larger than the influence in the UK. However, does this difference remain relevant in the context of the use of IFRS for consolidated statements? At first sight, it should not, because IFRS consolidated accounting is, even in Germany, separated from tax calculations which begin with the pre-tax accounting profit of unconsolidated individual entities. However, as explained below, there are two reasons why tax practice may influence IFRS consolidated statements: convenience (in Germany) and tax conformity (in the UK).

In Germany, companies are required to continue to prepare unconsolidated financial statements under the conventional rules of the HGB for calculations of taxable income and distributable income. This is irrespective of any use of IFRS for consolidated or unconsolidated statements (Haller and Eierle, 2004). In some areas, the tax-driven accounting choices of the unconsolidated statements might flow through to consolidated IFRS statements. For example, asset impairments are tax deductible in Germany (but not in the UK), so there is a bias in favour of them. They might survive into IFRS consolidations in Germany, given the room for judgement in IFRS impairment procedures (see Section 7.3).

In the UK, IFRS is allowed for individual company financial statements and therefore as a starting point for calculations of taxable income. The tax authorities generally expect the statements of a parent and the other UK group members to use the same accounting policies as used in the group statements. To take an example, the recognition and measurement of intangible assets has tax implications. Consequently, given that IFRS requires considerable judgement in this area, individual companies using IFRS will have an incentive to make interpretations of IAS 38 (Intangible Assets) in order to minimize capitalization (maximize expenses) and therefore minimize tax, and these interpretations will then flow through to consolidated statements.

Gee *et al*. (2010) examine the potential influence of tax on IFRS reporting in Germany and the UK. They conclude that there is scope for tax to influence accounting policy choices in several areas.

A way of summarizing this section is to say that national accounting traditions are likely to continue into consolidated reporting where scope for this exists within IFRS rules. This is not to suggest that this continuation of practices results merely from inertia, but that the reasons for the different traditions will in some cases remain relevant. However, inertia or habit might be a further explanation in itself. This is not necessarily bad, as there are advantages to inertia: it reduces disruption in accounting, which reduces administrative cost and makes interpretation easier for internal and external users.

7.3 Scope for varied IFRS practice

7.3.1 Introduction

Any motivations for varied IFRS practice among companies, industries or countries are of little importance unless there is scope for the variations to occur. This section examines this scope, concentrating on *international* differences, again mainly using Germany and the UK as examples.

Eight categories of scope for varied IFRS practice are identified: different versions of IFRS, different translations, gaps in IFRS, overt options, covert options, measurement estimations, transitional issues and imperfect enforcement. These are now considered in turn.

7.3.2 Different versions of IFRS

Despite adoption or alleged adoption of IFRS, international differences in the IFRS rules in force at a particular date can occur. Two cases are noted here. First, there are differences between IFRS and EU-endorsed IFRS, including some long delays in endorsement. These differences were examined in Section 5.4. The second case of difference within IFRS rules concerns implementation dates and year ends. New standards generally have an in-force date of ‘annual periods beginning on or after 1 January 200X’. However, early application is usually allowed, so two quite different versions of IFRS can be in force at the same time. For example, IFRS 15 was available for use (according to the IASB) in 2014, but not required to be used until 2018. Another aspect of this is that the EU endorsement process can take many months. So, some parts of IFRS might be available according to the IASB, but not EU-endorsed at a particular company’s year end. An EU company would not be allowed to use such parts of IFRS unless they were consistent with endorsed IFRS (KPMG, 2005). Examples of this are given in Section 5.4. The same general point applies in Australia, although the position is less complicated than in the EU because Australian-IFRS content comes into compulsory force on the same date as IFRS but earlier application is generally not allowed.

Furthermore, many companies in some countries (e.g. in Australia and the UK, but not in Germany) have accounting periods that do not begin on 1 January. Researchers

might therefore find that a sample of companies with annual reports relating to years ending in 2016 are subject to different versions of IFRS. More subtly, some companies (e.g. UK retail groups) choose to have accounting years comprising exactly 52 or 53 weeks, so some might have accounting years that begin on 28 December, thereby escaping a new standard that comes into force four days later.

7.3.3 Different translations

The IFRS Foundation (the parent organization of the IASB) has an official translation process for IFRS, including committees to review the quality of translations. There are official translations in many EU languages and, for example, in Arabic, Armenian, Chinese, Japanese, Kazakh and Russian.

In the case of the EU, the Regulation of 2002 gives the translations legal status in the various countries. EU and governmental representatives have been added to the IFRS Foundation's review committees, and the EU's Accounting Regulatory Committee (see Chapter 5) has also reviewed the translations.

As in any field, there is a risk that the process of translation will change or lose meaning from the original version, in this case English. Three examples are given here.

1 Cash flow statements are required by IAS 7, reconciling to 'cash and cash equivalents'. The term 'cash equivalents' is defined in paragraphs 6–9, including:

   > An investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months . . .

   This is an attempt to avoid writing a rule, as opposed to a principle. The Portuguese translation of IAS 7 omits the word 'say'. This improves the standard, but does not translate it accurately. As a result, it would be more difficult in Portugal than in Poland to argue successfully that an investment with a maturity of just over three months is a cash equivalent.
2 IAS 41 (paragraph 34) requires that an unconditional government grant related to a biological asset be recognized as income when the grant becomes 'receivable'. The Norwegian[1] version (DnR, 2006, page 543) translated this as '*mottas*', which means 'received'. This could sometimes be an important difference. The Norwegian version was corrected in 2012.
3 The German translation of IAS 19 required the discount rate for pension liabilities to be set by reference to *Industrieanleihen* (industrial bonds), whereas the original refers to corporate bonds (paragraph 78), which is a wider category. In the 2010 version of the IASB's official German translation, this is corrected to *Unternehmensanleihen*, but it remains wrong (in 2015, at the time of writing) in the EU's 'consolidated text'.

Evans (2004) examines the major problems of accounting communication when more than one language is involved. Zeff (2007) includes problems of translation and

[1]Norway, although not an EU country, has implemented the Regulation as a member of the European Economic Area.

terminology in his survey of obstacles to global comparability of financial reporting. Baskerville and Evans (2011) examine the complex issues to be considered when translating IFRS. Dahlgren and Nilsson (2012) give many detailed examples of translating IFRS into Swedish, noting several straightforward errors. However, they make the more general point that, because conceptual structures in different languages do not match perfectly, some accounting concepts are 'simply not translatable' (page 57). Evans *et al.* (2015) examine several aspects of the translation of accounting requirements, including learning lessons from other disciplines.

7.3.4 Gaps in IFRS

In a sense, there are no gaps in IFRS because IAS 8 (paragraph 10) tells an entity how to choose accounting policies when no other part of IFRS applies. In such a case, resort is made to the general criteria of the IASB *Framework*, to parts of IFRS related to the gap, and to more detailed standards of other bodies that use a similar *Framework* (most obviously, US GAAP). This leaves entities with considerable room for manoeuvre, and allows the continuation of variations in practice.

An example might be accounting for valuable works of art. It is unclear whether these are covered by IAS 16. Other special examples in 2015 were accounting for insurance contracts and for oil and gas exploration. The general topics are addressed by IFRS 4 and IFRS 6, respectively, but largely in order to exempt entities from following the normal approach of IAS 8. Under such circumstances, national traditions might continue as a way of filling any gaps in IFRS.

7.3.5 Overt options

As noted in previous chapters, in the early 1990s there were large numbers of options in international standards. The options have been gradually removed, particularly in 1993 and in 2003 as a result of two 'improvement' exercises. The term 'overt options' refers to options which are clearly visible in the standards, and for which the choices made by companies are clearly visible in their financial statements and notes.

Table 7.1 shows remaining examples of overt options in IFRS in 2005, assuming no early adoptions by companies of amendments to IFRS. Table 7.1 also shows (with asterisks) which of these options were removed by 2015. The list does not include the large number of options in IFRS 1 (first-time adoption of IFRS), but these are discussed in Section 7.3.8. A more extensive list is presented in Nobes (2013). The main issue for this chapter is whether options are exercised systematically differently from one jurisdiction to another, so that 'international accounting differences' survive.

Let us again take the examples of the UK and Germany, restricting ourselves as usual to the consolidated statements of listed companies. Tradition might be a major influence on the choices. For example (from Table 7.1), the following predictions were made relating to 2005 IFRS practices (Kvaal and Nobes, 2010):

- (IAS 1) UK groups would continue to use the financial position format of the balance sheet (see Section 2.9). For example, this is used in the model IFRS formats suggested by the UK firm of PricewaterhouseCoopers (2011). However, German groups would mostly continue to use the report format.

- (IAS 2) UK groups would mainly continue to use 'first in, first out' (FIFO), whereas many German groups would use weighted average because it is common under German national practice, given that FIFO is restricted by tax law (Kesti, 2005). 'Last in, first out' (LIFO) is also found in unconsolidated statements in Germany (see Chapter 15), but not allowed by IAS 2.
- (IAS 19) UK groups would take actuarial gains and losses immediately in full to other comprehensive income, whereas some German groups would continue to take them to profit or loss using the corridor (smoothing) approach.

Table 7.1 Examples of overt options in IFRS, 2005 and 2015 (without asterisks)[a]

IAS 1	No format requirements for statements of financial position or comprehensive income (paragraphs 54 and 82).
IAS 1*	Showing other comprehensive income as a second income statement or in a statement of changes in equity.
IAS 1	Permission to show comprehensive income in two statements (paragraph 81A).
IAS 2	FIFO or weighted average for the determination of the cost of inventories (paragraph 25).
IAS 2	Marking to market allowed for inventories of commodity broker-traders (paragraph 3).
IAS 7	Direct or indirect basis for calculating operating cash flow (paragraph 21).
IAS 7	Choice of classification for interest and dividend flows (paragraph 31).
IAS 16	Cost or fair value measurement basis for classes of property, plant and equipment (paragraph 29).
IAS 19*	Actuarial gains and losses could be taken (a) immediately in full to OCI, (b) immediately in full to profit and loss, (c) to profit and loss over the remaining useful lives of employees in the plan, or (d) to profit and loss faster than that.
IAS 20	Asset grants can be shown as a deduction from the asset or as deferred income (paragraph 24).
IAS 23*	Expensing or capitalizing interest on construction.
IAS 27	In parent statements, subsidiaries, joint ventures and associates can be shown at cost, using the equity method or as financial assets (paragraph 10).
IAS 31*	In group statements, there was a choice of proportional consolidation or equity accounting for joint venture entities.
IAS 38	Cost or fair value measurement for some types of intangible asset (paragraph 72).
IAS 39	Choice of cost basis or marking to market for some financial assets and liabilities (paragraph 9). (Other choices are also available in IAS 39 or IFRS 9.)
IAS 40	Permission to classify a property held under an operating lease as an investment property (paragraph 6).
IAS 40	Entity-wide choice of cost or fair value as measurement basis for investment property (paragraph 30).
IFRS 3	For measurement of a non-controlling interest in an acquiree, a choice of fair value or the share of the acquiree's net assets (paragraph 19).
IFRS 15	Estimating variable consideration as expected value or most likely amount (paragraph 53).
IFRS 15	Discounting or not revenue when customer pays in one year or less (paragraph 63).
IFRS 15	Expensing or capitalizing costs on contracts of one year or less (paragraph 94).

Note: [a]Paragraph numbers of extant options as at 1 March 2015.
Source: Adapted from Nobes, C.W. (2006) 'The survival of international differences under IFRS: towards a research agenda', *Accounting and Business Research*, Vol. 36, No. 3. Reproduced with permission.

- (IAS 40) UK groups would continue to use fair value for investment properties, but German groups would continue to use cost.

There is discussion of IFRS practices in Section 7.4.

7.3.6 Covert options

There is further scope for internationally varied IFRS practice because of different interpretations, covert options or vague criteria in IFRS. This is a different matter from different practice caused by the inevitable estimations involved in operationalizing the standards (see Section 7.3.7). Examples of covert options or vague criteria are shown in Table 7.2 and more are shown in Nobes (2013). Covert options are not designed to allow choice to entities, but the differential exercise of judgement might allow it in practice. Several of the topics are taken up in more detail later in this book. As may be seen, some of these depend upon what is 'probable'. Doupnik and Richter (2004) suggest that German accountants interpret the word 'probable' (which occurs in many places in IFRS) more conservatively than US accountants.

An example of a covert option from Table 7.2 is the capitalization of development costs, as required by IAS 38. Under EU national rules, capitalization was in some cases banned (e.g. in Germany) and is in some cases allowed but not required (e.g. in the UK). There were no EU national rules which contained a *requirement*, like that of IAS 38, to capitalize when certain criteria are met. A famous example of the importance of this is Volkswagen's voluntary transition to IFRS from German accounting in 2001 (see Section 2.9): the increase in shareholders' equity caused by capitalization of development costs was 41 per cent. A similar large effect occurred for BMW.

As there are no large listed UK car companies, no direct comparisons can be made with these German examples. However, capitalization depends on demonstrating that all of a list of vague criteria are met, such as feasibility of completion, intention to complete, and availability of adequate resources to complete (IAS 38, paragraph 57). Therefore, there is scope for deliberate or unconscious systematic international difference, driven by the factors discussed in Section 7.2. For example, as explained there, it is clear that German capitalization for IFRS consolidation purposes has no tax implications, whereas the position for the UK is different because tax considerations can affect accounting practice on this topic, and this could flow through to consolidated statements. On the other hand, capitalization runs far more against the German tradition of conservatism than it does against the British tradition.

Another way of looking at covert options is that the existence of the IFRS Interpretations Committee is evidence of the potential for different interpretations of standards. The IASB's preference for principles-based rather than rules-based standards (see Chapter 5) means that it tries to avoid detailed prescription. The Interpretations Committee publishes lists of topics that have been raised with it, but that it has decided not to deal with. At least two answers were thought plausible by those who raised these topics.

7.3.7 Measurement estimations

Table 7.3 gives some examples of IFRS measurement estimations (as opposed to estimates related to recognition, as in Section 7.3.6). An example of a measurement

Table 7.2 Examples of covert options or vague criteria in IFRS, 2005 and 2015 (without asterisks)[a]

IAS 1	Determination of whether a liability is current on the basis of the expected date of settlement or purpose of holding (paragraph 60).
IAS 8	The determination of materiality for various purposes (paragraph 5).
IAS 11*	Use of percentage of completion method only if the outcome of a contract can be estimated reliably.
IAS 12	Recognition of a deferred tax asset for a loss carryforward only if future taxable profit is probable (paragraph 34).
IAS 12	Recognition of a deferred tax liability on unremitted profits from subsidiaries only if dividends are probable in the foreseeable future (paragraph 39).
IAS 17	Lease classification based on 'substantially all the risks and rewards' with no numerical criteria (paragraph 8).
IAS 21	Determination of functional currency based on a mixture of criteria (paragraphs 9–12).
IAS 23*	Cessation of capitalization of borrowing costs when 'substantially all' the activities to prepare the asset are complete.
IAS 28	Identification of an associate on the basis of 'significant influence' (paragraph 6).
IAS 36	Identification of an indication of impairment based on a mixture of criteria (paragraphs 12–14).
IAS 37	Recognition of a provision based on probability of outflow of resources (paragraph 14).
IAS 38	Capitalization of development costs when all of various criteria are met (paragraph 57).
IAS 38	Amortization of intangible assets only if useful life is assessed as finite (paragraph 88).
IAS 39	Use of cost basis where equity instruments cannot be measured reliably (paragraph 46).
IAS 39	Estimation of hedge effectiveness as a condition for use of hedge accounting (paragraph 88).
IAS 40	Use of cost basis, despite entity-wide choice of fair value, for an investment property whose fair value cannot be measured reliably (paragraph 53).
IAS 41	Use of cost basis for a biological asset whose fair value cannot be measured reliably (paragraph 30).
IFRS 3	Identifying the acquirer in a business combination presented as a merger of equals (paragraph 6).
IFRS 5	Treatment of assets as held-for-sale if expected to be sold within one year (paragraph 8).
IFRS 8	The determination of reportable segments based on a mixture of factors (paragraph 11).
IFRS 10	Identification of a subsidiary on the basis of 'power over an investee' (paragraph 7).
IFRS 15	Estimating variable consideration (paragraph 50).

Note: [a]Paragraph numbers of extant options as at 1 March 2015.
Source: Adapted from Nobes, C.W. (2006) 'The survival of international differences under IFRS: towards a research agenda', *Accounting and Business Research*, Vol. 36, No. 3. Reproduced with permission.

estimation is that, for depreciation, it is necessary to assess an asset's expected useful life and residual value. The depreciation method (e.g. straight line or reducing balance) is also an estimate and not a policy choice, because which method is appropriate depends on how the asset wears out.

Tradition, convenience and tax will all play roles here. UK tradition (FEE, 1991) is that a convenient method is used (typically for plant: straight line, zero residual value and ten-year life). This is done in the knowledge that an entirely separate scheme of capital allowances operates for tax purposes (see Section 2.5). German tradition was (Haller, 1992), and for unconsolidated statements remains, to accelerate expenses by using the minimum lives allowed by tax law and the reducing balance method (but changing to straight line near the end of an asset's life).

Table 7.3 Examples of measurement estimations in IFRS, 2015

IAS 2	Net realizable value of inventories (paragraphs 30 and 31)
IAS 12	Tax rate for deferred tax calculations based on the expected manner of settlement or recovery (paragraph 51)
IAS 16 (and IASs 17, 38, 40)	Depreciation (or amortization) based on estimates of useful life, residual value and pattern of consumption (paragraphs 50, 51 and 60)
IAS 16 (and IASs 38, 40)	Fair value when selected as a measurement basis (paragraphs 31–34)
IAS 19	Pension obligations based on estimates of mortality, final salary, etc. (paragraph 57)
IAS 36	Discounted cash flows or net realizable values for impairments (paragraph 18, etc.)
IAS 37	Best estimate of provisions based on percentage likelihoods of outflows (paragraph 40)
IAS 39/IFRS 9	Fair values for certain financial assets and liabilities (IAS 39, paragraph 48)
IAS 41	Fair values for biological assets (paragraph 12)
IFRS 2	Fair value of equity instruments (e.g. share options or shares in an unlisted company) granted to employees (paragraph 11)
IFRS 3	Allocation of cost of a business combination to assets and liabilities of acquiree based on fair values (paragraph 18)

Source: Adapted from Nobes, C.W. (2006) 'The survival of international differences under IFRS: towards a research agenda', *Accounting and Business Research*, Vol. 36, No. 3. Reproduced with permission.

It is clear that the tax-based useful lives and other estimates should be abandoned by German groups for IFRS purposes. For example, Volkswagen's transition showed an increase in shareholders' funds of 36 per cent as a result (see Section 2.9). Related to this, reducing balance has largely been abandoned for German IFRS statements, partly perhaps because an amendment to German law had already required the removal of tax-based policies from consolidated statements prepared under German domestic rules. However, in some other EU countries, reducing balance might continue under IFRS.

7.3.8 Transitional issues

One transitional issue has already been dealt with in Section 7.3.2: sometimes a new standard allows a period during which its requirements are merely encouraged. However, some other transitional issues can lead to long-run effects on IFRS financial statements. IFRS 1 allows several options for companies moving from national rules to IFRS for the first time. One of these concerns goodwill. As explained in Section 4.3, goodwill requirements have changed greatly over the years. UK practice was generally to show goodwill purchased up to 1998 at zero, and to amortize subsequent goodwill over 20 years. In other countries (e.g. France) goodwill had always been capitalized. On transition to IFRS, the old national goodwill figures were allowed to be retained. This particular point is illustrated by the difference between the IFRS and US figures for Glaxo for 2005 and 2006 in Table 1.1. The main explanation is the lack of goodwill in balance sheets under old UK rules, and this was carried forward into the opening IFRS statements. The different national starting points will affect IFRS statements for many years to come.

7.3.9 Imperfect enforcement

The last of the suggested sources of scope for international differences, despite a requirement to use IFRS, is that the degree of enforcement of rules (and therefore compliance with them) varies internationally. As noted earlier, enforcement (including monitoring) of compliance with IFRS remains a national matter. This issue is discussed in Chapter 20, where research is summarized that shows German compliance with accounting rules used to be lower than that in the UK. If compliance is low in some countries, then practice under alleged IFRS may vary from IFRS requirements.

7.4 Examples of varied IFRS practice

The extensive use of IFRS in Australia and the EU from 2005 onwards has enabled a study of the variations in IFRS practice. KPMG and von Keitz (2006) look at 199 IFRS reports of the largest companies of ten countries (seven of them in the EU), using year ends in 2005. The latter point excludes the first implementation by many UK companies,[2] and also means that countries such as Australia[3] were excluded. The KPMG study reports on the choice of options, in some cases including a breakdown by country. However, that study is not designed to produce a formal comparison of practices between countries. ICAEW (2007) reports on a survey of 200 listed companies of all sizes across 24 EU countries for 2005–6. In general the data on choice of options are aggregated rather than shown by country, although there are some exceptions. The ICAEW report shows extensive variety in the use of IFRS options, by country and by sector. However, it found that there was little use of the options to measure assets at fair value, except by financial institutions for financial assets. A survey of 2006 annual reports (Commission, 2008) has similar findings.

The above surveys note a great variety in the treatment of pension costs. Morais (2008) examines 523 European companies in 2005 to discover their choice of treatment of actuarial gains and losses under IFRS. She finds that UK and Irish companies make noticeably different choices from others, consistent with previous practices there.

Kvaal and Nobes (2010) examine the IFRS reports for 2005–6 of all the companies in the main stock indices of Australia, France, Germany, Spain and the UK: 232 companies in all. They find a similar national bias in IFRS practice to that found by Morais, but they cover 16 of the overt IFRS options of Table 7.1 rather than just one of them. Nobes (2013) updates the data and adds a few more countries, as shown in Table 7.4. As may be seen, traditional pre-IFRS practices tend to survive. For example (topic 2 in Table 7.4), Australian and UK companies show 'net assets' in balance sheets, whereas the continental European companies focus on 'total assets'. Many Australian and UK companies use fair value for investment properties (topic 6 in Table 7.4) but none of the continentals do. The conclusion is that there is a German version of IFRS practice that is statistically significantly different from a UK version, and so on. As explained

[2] Many UK companies do not have 31 December year ends, so their first IFRS reports related to years ending in 2006.
[3] Australian usage of IFRS began, for most companies, on 1 July 2005.

Table 7.4 Percentages of companies choosing particular IFRS options, 2008[a]

		Aus	Can	UK	Ger	Fra	Spa	NL	Ita	Swe
1 (b)*	Balance sheet shows net assets	100.0	0.0	85.2	0.0	0.0	0.0	14.3	0.0	0.0
2 (a)*	Cash at top of balance sheet	100.0	100.0	0.0	30.4	0.0	4.8	14.3	21.4	0.0
3 (a)*	Income statement by function	58.3	87.5	82.1	82.6	62.1	4.8	50.0	7.1	95.0
4 (a)*	Equity profit in 'operating'	68.8	30.8	40.4	23.3	10.7	0.0	0.0	0.0	93.3
5 (b)†	Only SORIE/OCI presented	67.5	–	90.6	33.3	14.7	32.1	41.1	18.8	23.1
6 (b)*	Indirect operating cash flows	8.3	100.0	100.0	100.0	100.0	95.2	100.0	100.0	100.0
7 (a)*	Interest paid as operating flow	81.5	74.3	65.1	60.9	80.0	42.9	78.5	85.7	90.0
8 (b)	Some PPE at fair value	15.4	7.9	13.4	0.0	0.0	0.0	11.8	0.0	3.8
9 (b)	Investment property at fair value	73.3	40.0	72.7	10.0	12.5	6.3	75.0	0.0	100.0
10 (a)*	Some fair value designation	29.2	35.3	12.7	17.4	33.3	19.0	75.0	12.5	52.6
11 (a)†	Interest capitalization	87.1	–	57.4	41.7	44.4	100.0	66.6	33.3	33.3
12 (b)*	Weighted average only	52.9	63.0	30.0	76.2	50.0	83.3	41.7	78.6	10.0
13 (a)	Actuarial gains/ losses to OCI	86.7	79.6	85.4	63.3	50.0	57.8	31.3	24.0	20.0
14 (a)	Proportional consolidation of JV	11.5	63.0	22.6	15.8	75.8	88.0	46.0	40.0	33.3

Notes: The table shows the companies choosing a particular policy as a percentage of the companies exhibiting a policy for the topic.
[a]2011 for Canada.
*Non-financial companies only.
†Options removed for 2011 statements or before.
Source: Nobes, C.W. (2013) The continued survival of international differences under IFRS, *Accounting and Business Research*, Vol. 43(2), pp. 83–111.

in Chapter 3, Nobes (2011) prepares a classification which shows that Australian and UK practices under IFRS are somewhat similar, and that IFRS practices in different continental European countries are also somewhat similar.

Kvaal and Nobes (2010) had suggested that the study of the very largest listed companies meant that their findings of internationally varied IFRS practice were robust. That is, K&N expected that smaller firms would be less interested in international comparability and would therefore exhibit even clearer country-related patterns of

policy choice. Indeed, some of the IFRS choices made by the large companies seemed out-of-line with pre-IFRS national traditions. For example, the large German companies mostly chose by-function income statements (see topic 3 in Table 7.4), presumably to be in line with the majority practice on the New York and London exchanges, whereas the by-nature format had been traditional German practice and, until 1987, the legal requirement.

Nobes and Perramon (2013) investigate this issue. They take the 2008/9 data of Kvaal and Nobes (2012) as it relates to non-financial companies. Then they hand-pick data on the IFRS policy choices made in 2008/9 by a sample of the smallest listed companies of the same five countries. They find, for 12 of their 15 topics, that the policy choices are significantly different between the small and large companies for at least some countries. This includes the German choices related to the income statement, noted above, in that the small German companies mostly chose the traditional by-nature format. As noted in Chapter 5, Ball (2006) warned that international uniformity was unlikely to follow from the adoption of IFRS. This seems to be especially true for smaller listed companies.

As mentioned in Chapter 2, Jaafar and McLeay (2007) investigated whether sector-specific policy choices lay behind some of the international differences. They found only a small effect of sector compared to that of nationality. However, they studied pre-IFRS practices, which means that some (perhaps most) of the effect of nationality was caused by international differences in accounting *rules* rather than in policy choice. Stadler and Nobes (2014) study the influence of various factors in the context of IFRS, when all the companies are following the same rules. They note that, despite the strong association of policy choice and country, the IFRS practices within a country are not uniform. They, therefore, investigate the degree to which IFRS policy choices are driven by sector, firm or policy-specific factors, as well as by country. They use the 2008/9 data relating to non-financial companies as collected by Kvaal and Nobes (2012). Their firm-specific factors include size and leverage. The policy-specific factors relate to the effects on accounting numbers of the policy choice; for example, if a company already has high gearing, it might be disinclined to choose proportional consolidation of joint ventures, which would increase gearing. Stadler and Nobes find that the very strong association of policy choice and country largely survives the inclusion of variables for sector, firm and policy.

Wehrfritz and Haller (2014) attempt the more difficult task of assessing whether there are international differences in IFRS recognition practices and estimations (see 7.3.6 and 7.3.7). They undertake a questionnaire survey of German and UK accountants, to investigate potential differences in the area of the recognition and measurement of provisions. However, they find difficulty in matching their samples, and they cannot confirm much international difference in practice.

7.5 Changes in IFRS practice over time

For most of the companies studied by Kvaal and Nobes (2010), the financial statements examined were the first prepared under IFRS. This raises the question whether the influence of pre-IFRS practices (and the resulting patterns of national IFRS

practice) was mostly a feature of transition to IFRS and might therefore dissipate over time. In order to investigate that, Kvaal and Nobes (2012) examine the IFRS policy choices of the same companies but three years later. They expect the influence of pre-IFRS policies (and therefore nationality) to continue, not least because IAS 8 constrains policy change.

Kvaal and Nobes (2012) examine the 126 policy changes over their three-year period among the companies in their sample. They discover little change among Australian and UK companies but significantly greater change by French and Spanish companies. Remarkably, the French and Spanish companies changed their policies more after transition (despite the constraints of IAS 8) than they had done at transition (when IFRS 1 imposes no constraints). For Australian and UK companies, the reverse was the case.

Kvaal and Nobes (2012) ask what might explain this. They suggest that French and Spanish companies had been the furthest away from the culture, ethos and requirements of the IASB, so were least aware of the possibilities for change at transition. Kvaal and Nobes test this by recording, for each post-transition policy change, whether the change was towards or away from the pre-IFRS requirement under national GAAP. They find that most of the few Australian and UK changes were towards the pre-IFRS national requirement, suggesting that the companies were not learning from foreign companies, but were perhaps interested in comparability among their national peers. However, the many French and Spanish post-transition changes were mostly away from the pre-IFRS national norms, suggesting some learning, perhaps from the practices of companies listed on the London stock exchange as the largest in the world to be based on reporting under IFRS.

Haller and Wehrfritz (2013) also use Nobes (2006) as a starting point. They examine the IFRS policy changes of German and UK companies from 2005 to 2009. Like Kvaal and Nobes (2012), they find few policy changes among companies of those countries.

Australia presents a special case because the initial Australian implementation of IFRS had deleted certain non-Australian options, such as the indirect method of calculating operating cash flows (topic 6 in Table 7.4). However, for 2007 onwards, the options were reinserted. Bond *et al.* (2012) find that less than 1 per cent of all Australian listed companies had changed from the direct to the indirect method by 2009. This again illustrates the remarkable persistence of national practices. Incidentally, research suggests that the direct method provides better predictions of future cash flows (Bradbury, 2011; Farshadfar and Monem, 2013).

7.6 Implications

This chapter has addressed the question of whether there are motives and scope for varied practice within IFRS. Although the question is relevant between individual companies or industries, the focus here has naturally been international.

Section 7.2 concluded that the motives for international difference, as examined in earlier chapters, are still applicable in modified form. Section 7.3 investigated the scope for different IFRS practice under eight headings. As part of doing this, extensive

tables of IFRS overt options, covert options and measurement estimations were provided, and these can be studied as extensions of the coverage of the content of IFRS in Chapter 6.

Over time, some of the scope for IFRS variations will be removed. For example, the IASB will continue to remove overt options, fill gaps and narrow possible interpretations. Also, the transitional differences will be eroded. Nevertheless, users of IFRS financial statements will have to be on their guard because, for example, a German version of IFRS practice is likely to continue to be different from a UK version.

A further implication relates to the SEC's monitoring of IFRS practice, as part of its decision-making about whether to allow IFRS for US registrants. Diverse practice will weaken the case for adoption of IFRS.

Lastly, students and teachers can be assured that 'comparative international accounting' will still exist as a field of study, despite the onset of IFRS.

SUMMARY

- Some aspects of the reasons for international differences in reporting still apply as motives for international variations in IFRS practice.
- Relevant factors include financing systems, legal systems and tax systems.
- Eight types of category are suggested as scope for varied practice within IFRS.
- There are different national or regional versions of IFRS and different translations.
- There are also gaps in IFRS, overt options, covert options, scope for different measurement estimations, and transition options.
- Enforcement of IFRS varies internationally because it remains a national legal matter.
- The existence of different national versions of IFRS practice is a new feature of comparative international accounting. It has implications for users of financial statements and for US acceptance of IFRS statements.

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

7.1* To what extent are the reasons for different European accounting systems still relevant as reasons for different European IFRS practices?

7.2* Give examples of options allowed in IFRS and how they might be chosen differently in different countries.

7.3 'The influence of tax on financial reporting cannot be relevant in the context of IFRS consolidated statements.' Discuss.

7.4 To what extent has the scope for different practice under IFRS declined over the past decade?

7.5 If it is found that large differences in IFRS practice exist systematically between countries, what implications does this have?

7.6 If a translation of IFRS exists in a language with which you are familiar, assess the quality of the translation.

8 Financial reporting in the United States[1]

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Summary

[1]This chapter is a considerably amended version of that in the first edition by Sir Bryan Carsberg and Alf Eastergard, who both worked for the Financial Accounting Standards Board at the time.

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OBJECTIVES

After reading this chapter, you should be able to:

- explain the procedures for the setting and enforcement of accounting standards in the United States, including the relationships between public- and private-sector institutions;
- describe the main features of the presentation of US financial statements;
- explain the US accounting requirements on major topics;
- outline the main differences between US GAAP and the requirements of international standards.

8.1 Introduction

International standards (IFRS) have been examined in some detail in Chapters 4–7. Most of the listed companies in the world that still do not use IFRS (or a system based on it) use US accounting. This chapter examines US GAAP and the US regulatory system headed by the SEC. A volume of great length would be required to present a comprehensive description and analysis of financial reporting regulation and practices in the United States. In discussing those practices in a single chapter, we have had to be selective and have focused on topics in which the choice of acceptable practice may be expected to affect significantly the amounts of income and net worth reported by an enterprise. More detail on the US and other enforcement regimes is contained in Chapter 20.

US accounting was originally an export from the United Kingdom, like the American language and the American legal system. Such founding fathers of US accounting as Arthur Young and James Marwick (whose names are now incorporated into the names of the accounting firms EY and KPMG, respectively) were expatriate Britons. The names of persons who are recalled in the names of the other two big firms in the US (i.e. Deloitte, Price, Waterhouse, and the Cooper brothers) are all British, revealing the origins of the firms. Further, in terms of the causes of differences discussed in Chapter 2 (such as the legal system and the financing system), the United States and the United Kingdom are reasonably similar in a world context, although regulation of accounting differs. Compared to China, France, Germany or Japan, the accounting practices of UK GAAP and US GAAP have also been somewhat similar. If countries are to be classified, these similarities suggest that the United States and the United Kingdom are in the same family. However, the view that there is such a thing as Anglo-American or Anglo-Saxon accounting has been criticized (as explained in Section 3.9).

One key similarity between UK and US accounting is the degree to which the financial reporting rules are separate from the tax rules (see Lamb *et al.*, 1998, for a

detailed analysis). This means that tax rules are a minor influence on financial reporting, although the exception of LIFO (last in, first out) is noted in Section 8.6.5 below.

Given the adoption of IFRS for consolidated reporting by UK listed companies, a more important issue now than US/UK similarity is US/IFRS similarity. As noted already in this book, US influence on the accounting of other countries and on international standards has been considerable. However, from 2001, with the creation of the IASB coinciding closely with a series of accounting scandals in the United States, US accounting has been influenced from outside, especially by convergence with IFRS.

After this introduction, there is an examination of the regulatory framework (Section 8.2), especially the SEC, which demands the world's most extensive disclosures from public companies. We then examine the US standard-setting process (Section 8.3), leading to consideration of the conceptual framework (Section 8.4) and some detailed accounting and auditing topics (Sections 8.5 to 8.8). At the end of the chapter (Section 8.9) there is a comparison with IASB requirements.

8.2 Regulatory framework

8.2.1 Laws

The United States is a federation of individual states, each of which has its own legislative body with extensive powers to control business activity and levy taxes within its own boundaries. The setting up of companies and such issues as the distribution of profits to shareholders are controlled by state laws. The right to practise as a public accountant is also conferred by the individual states, and the requirements for conferring it differ slightly from state to state. Membership of the national body, the American Institute of Certified Public Accountants (AICPA), is not a condition for practising, and many practitioners elect not to become members. So, the number of CPAs recorded in Table 1.11 does not include all those with the right to practise.

Laws governing transactions in securities were first introduced by individual states, beginning with Kansas in 1911. Such state laws became widespread; they are generally known as 'blue sky laws', after a quip to the effect that unscrupulous Kansas dealers were trying to sell the blue sky. The laws normally require registration of any proposal to offer securities for sale, and disclosure of information; in some cases they confer on a state official the right to refuse permission for the proposal.

The most important regulations for the control of dealings in securities are enforced at the federal level under the Securities Act of 1933 and the Securities Exchange Act of 1934, which were passed after the financial crises of 1929 onwards, including the 'Wall Street Crash'. However, neither these statutes nor any others contain detailed provisions relating to financial reporting. The United States has no statutory requirements for accounting in a form that is comparable to the accounting sections of the Companies Acts in the UK or commercial codes in some other EU countries (see Chapter 14). The United States has dealt with the need for accounting rules in a different way. The federal securities legislation established the SEC in 1934 to administer the securities regulations. The primary

function of the SEC is to ensure that investors are given the information necessary for informed investment decisions. It requires publication and receives registration of prospectuses and periodic financial reports. It also has the power to prescribe the methods to be followed in the preparation of financial reports and to prescribe the form and content of those reports. The SEC's focus on information for existing and potential investors is different from the legal focus of UK and other European laws, which is the protection of existing shareholders or creditors. One result is that US regulators are less interested in prudence and stewardship than some other regulators are.

One vital point is that only a small minority of US companies (about 11,000) are SEC-registered and have to obey the SEC's accounting and auditing rules. As noted above, a company must register with the SEC if it wants a market in its securities. Once registered, it has to publish financial statements, file reports, have CPA audits, follow the Regulations of the SEC (see below), and comply with GAAP. As you read this chapter, remember that US rules are also used by some companies based outside the United States. This usage is still controlled by the SEC if, for example, the foreign company is listed on the New York Stock Exchange and does not file financial statements that comply with IFRS as issued by the IASB. Around 1,150 foreign companies are registered with the SEC. In other cases, a foreign company may have approximately adopted US rules in order to impress investors.

Other companies (private companies) have no compulsory audit or published financial reporting, although many companies are required to publish audited statements by their shareholders or lenders. In 2007, the FASB and the AICPA set up the Private Company Financial Reporting Committee in order specifically to make recommendations to the FASB concerning private company accounting. For example, cost–benefit considerations might suggest that private companies should be exempted from some disclosures. The Committee made recommendations to the FASB, but the Committee was replaced at the end of 2012 by the Private Company Council. However, no decisions have yet been made (at the time of writing in mid-2015) about amending US GAAP for private companies.

Originally, GAAP meant what it said; that is, a set of high-level principles endorsed by respectable companies, auditors and textbooks. However, from the 1930s onwards, rules have gradually been written down (or 'promulgated') and eventually codified, as explained later. As a result, codified GAAP is now a large body of instructions: it is not 'principles' but detailed rules, and it is not 'generally accepted' but written down by bodies approved by the SEC, and then enforced in detail by the SEC. The contrast between principles and rules was discussed in Chapter 5, where it was noted that even a detailed set of rules can be principles-based.

8.2.2 The Securities and Exchange Commission

The Commission comprises five members appointed by the President of the United States, and it acts as an independent regulatory body with quasi-judicial powers. The SEC has a large staff supporting the five commissioners. When a new US president is appointed, a new SEC takes office, as in 2009 with the inauguration of President Obama. As mentioned in Chapter 5, this can affect projects that are in progress, such as the proposals to consider whether to require IFRS.

The SEC has issued a large number of statements on accounting matters. However, these have related mainly to the details of registration rather than to accounting standards. Regulation S-X contains rules for the preparation of financial reports by registered companies. Form 10-K, containing the reports and extra information, must be filed annually within 60 days of the year end in the case of the largest companies. Form 10-Q contains quarterly reporting. Form 8-K is used to disclose (within four days) any interesting developments (e.g. the issue of more shares).

The Commission sometimes issues instructions on how to do accounting in 'Accounting Series Releases' or more recent 'Financial Reporting Releases'. There are also 'Staff Accounting Bulletins' (see below). However, the SEC has tended to limit the exercise of its accounting standard-setting authority to a supervisory role, permitting and encouraging the private sector, currently through the FASB, to maintain leadership in the standard-setting process (see Section 8.3). In 1973 the SEC issued Accounting Series Release No. 150, *Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards*, in which it reaffirmed its intention to maintain a supervisory role:

> In meeting this statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors.
>
> The body presently designated by the Council of the American Institute of Certified Public Accountants (AICPA) to establish accounting principles is the Financial Accounting Standards Board (FASB). . . . The Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles . . .
>
> . . . For purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.

It is important to note that the SEC does not 'delegate' powers to the FASB. As Zeff (2010) points out, the SEC would not legally be allowed to do so. In the course of monitoring the performance of the FASB in the standard-setting process, the staff of the SEC maintain regular communications with the staff of the FASB. The Commission might have reached different conclusions from those reached by the FASB on some of the topics on which the Board has issued pronouncements. However, the Commission has only interfered publicly in matters that fall within the terms of reference of the Board in a few special cases (see Chapter 10). The SEC has used its legislative authority to hasten the adoption of new practices, although it made clear its wish that the FASB should take over the job of further standard-setting. Nevertheless, what matters in the end to companies and auditors is how the staff of the SEC interpret an accounting standard. On many topics, the answer to this is given in a series of published *Staff Accounting Bulletins* from the SEC, which become part of GAAP.

The accounting scandals of Enron and WorldCom of 2001/2, which were followed by the collapse one of the Big-5 accounting firms (Andersen), led to the Sarbanes-Oxley Act (see below). It also led to the creation by Congress of the Public Company

Accounting Oversight Board (PCAOB), which is overseen by the SEC (Carmichael, 2004). At the same time, the accounting duties of directors and the independence requirements of auditors were increased (see Section 8.8). The credit crunch and related financial disasters of 2008 onwards led to further reform of the SEC and other aspects of regulation.

8.2.3 The United States Congress

The US legislative authority – Congress – has occasionally taken a direct interest in accounting matters, although it has usually relied on the SEC to look after the public interest. However, some exceptions to that practice are illustrative. The first concerned the investment credit, a provision of tax law designed to give an incentive for the purchase of productive assets. The credit was a deduction of a percentage of the cost of new assets from the tax liability for the year in which the assets were first used. The introduction of the credit led to a controversy about the timing of its recognition in earnings. Some believed that the credit should be added to earnings in the year for which it was given; others believed that it should be spread over the life of the asset concerned. Eventually, the private sector standard-setting authority proposed to require the use of one method – the spreading of the credit over the asset's life. However, before that proposal was finalized, the Congress passed legislation (the Revenue Act of 1971) to prevent any standard-setting body from limiting the acceptable methods of accounting for the investment credit in reports filed with any government agency, including the SEC.

This action of Congress was apparently motivated by a concern not to reduce the incentive effect of the tax credit. Congress recognized that it would be unfortunate if accounting standards were to produce an unfavorable pattern of earnings when optimal decisions were being taken, and hence to give an incentive to the taking of 'uneconomic decisions'. Today, it is widely accepted that accounting standards should, as far as possible, have a neutral effect on economic decisions. The FASB has sponsored research to estimate the economic consequences of its standards. The action of Congress may be seen as the forerunner of the concern about the neutrality of standards. Incidentally, the investment credit was abolished from 1986 as part of a general tax reform.

The 'politicization' of accounting in the United States has been commented on by Solomons (1978) and Zeff (1978), and more recently again by Zeff (1997) and Mozes (1998), who describe a major battle between standard-setters and elements of government on the subject of accounting for stock options (see Section 8.6). There was further involvement by Congress on the reform of accounting for business combinations caused by opposition from companies to the banning of pooling accounting (Beresford, 2001). As mentioned above, Congress intervened in 2002 by passing the Sarbanes-Oxley Act, often abbreviated to SARBOX or SOX. This is not largely about accounting, but about controlling managers and auditors. However, it did increase the disclosure requirements about special purpose entities that are not included in consolidated statements. Various examples, and the general topic of political involvement in standard-setting, are examined in detail in Chapter 10. Zeff (2005) surveys the effects of political lobbying on US standard-setting.

8.3 Accounting standard-setters

8.3.1 Standard-setting by the profession

The first private-sector body to become involved with the systematic development of US accounting standards was the Committee on Accounting Procedure established by the AICPA in 1936 soon after the SEC was founded (Davidson and Andersen, 1987). The Committee produced 51 publications known as 'Accounting Research Bulletins' during the period 1939–59. The Committee was replaced, in 1959, by the Accounting Principles Board (APB) which published 31 Opinions and four Statements up to 1973. Pronouncements of the Committee and of the APB remain in force if they have not been amended or superseded by action of the FASB. Zeff (1972) examines standard-setting in the US and other countries in this period.

In 1971, growing dissatisfaction with the procedures for setting accounting standards led the AICPA to establish two committees to review those procedures. One source of dissatisfaction was that the APB was dominated by the accounting profession; there were insufficient provisions to ensure that the opinions of other interested parties were taken into account. The Wheat Committee was given the task of studying this problem. Its 1972 report, *Establishing Financial Accounting Standards*, led to the formation of three new bodies: the FASB, responsible for setting standards; the Financial Accounting Foundation (FAF), responsible for appointing members of the Board and for raising finance; and an advisory body, the Financial Accounting Standards Advisory Council (FASAC). Zeff (2015) examines the crisis in standard-setting that led to these developments, and explains how the Wheat Committee reached its conclusions.

One second source of dissatisfaction with the APB was its limited progress in identifying fundamental concepts that would put the development of accounting standards on a surer foundation. The Trueblood Committee was formed to prepare a report on the objectives of financial reporting – a first step in the development of the FASB's conceptual framework project (see Section 8.4).

British readers will note that somewhat analogous reports to Wheat and Trueblood were published in the United Kingdom (Dearing in 1988, and Solomons in 1989) leading to similar results, including the creation of the Accounting Standards Board. Similarly, the three US bodies (FASB, FAF and FASAC) all have their equivalents in the reforms that set up the IASB in 2001 (see Chapter 4). Table 8.1 records the US and international bodies.

Although the AICPA gave up its role as the main standard-setter, it still issues detailed guidance called 'Statements of Position', concentrating from 2003 on industry-specific guidance.

8.3.2 Financial Accounting Standards Board

Since 1973, the FASB has been the SEC's designated organization in the private sector for establishing standards of financial reporting in the United States. It is funded by voluntary contributions from public accounting firms, industry, investor and creditor organizations and various related organizations and individuals. Each annual contribution is limited to ensure the Board's independence from undue influence.

Table 8.1 Standard-setting structure

Body	US	International
Governing Trust	Financial Accounting Foundation	IFRS Foundation
Board	Financial Accounting Standards Board	International Accounting Standards Board
Advisory Council	Financial Accounting Standards Advisory Council	IFRS Advisory Council
Interpretation Body	Emerging Issues Task Force	IFRS Interpretations Committee

The members of the FASB (originally seven, reduced to five in 2008, but now seven again) serve full time and are required to sever all previous business or professional connections before joining the Board. They have diverse backgrounds; not all are recruited from public accounting firms.

Until 2009, the FASB issued Statements of Financial Accounting Standards (SFASs), Statements of Financial Accounting Concepts, and Interpretations which clarify, explain or elaborate existing standards. In 2009, the FASB issued a 'codification' of all previous GAAP; that is, it re-arranged all of its own and the prior standards into topic areas. Readers will notice that many academic papers refer to particular past developments using the name or number of the original standard, such as SFAS 52 on foreign currency translation. We do that, too, in this book when discussing historical developments. However, references to current GAAP should now be to the relevant part of the Accounting Standards Codification (ASC). The FASB has also issued a number of concepts statements that are primarily used by the Board itself to guide the development of standards. They do not contain standards for direct application in themselves. Section 8.4 examines this.

Before it issues amendments to GAAP, the FASB is required by its rules to follow extensive 'due process'. In connection with each of its major projects, the Board:

- appoints a task force of technical experts representing a broad spectrum of preparers, auditors and users of financial information to advise on the project;
- studies existing literature on the subject and conducts such additional research as may be necessary;
- publishes a comprehensive discussion of issues and possible solutions as a basis for public comment;
- conducts a public hearing;
- distributes an exposure draft of the proposed amendment for public comment.

The resulting amendment is published as an 'Accounting Standards Update' which is then absorbed into the ASC.

The FAF has about the same size of annual budget as the IFRS Foundation, but that includes setting governmental accounting standards. Nevertheless, the FASB's operations are much more extensive – and its budget larger – than any other national standard-setter. The substantial number of technical staff conduct research, participate in

public hearings, analyze oral and written comments received from the public and prepare recommendations and drafts of documents for consideration by the Board.

A further aspect to the workings of the FASB has been the Emerging Issues Task Force (EITF), set up in 1984. This is a committee with members from the large accountancy firms and from companies, with the AICPA and the SEC as observers. The EITF examines newly apparent problems that require rapid guidance on what is to be generally accepted. Its conclusions are made public and become part of the ASC.

In 2001/2, the difference between US 'rules-based' standards and IASB 'principles-based' standards was highlighted because of the spectacular collapses of some large companies (e.g. Enron). The FASB (2002) issued a consultative document on the issue. Despite this, the FASB issued a standard (SFAS 162) in 2008 that made it even clearer than before that US GAAP does not allow departures from the rules in the name of the need to give a 'fair presentation'.

In 2002, the FASB announced a joint project (the 'Norwalk Agreement') with the IASB to remove as many differences as possible between their standards by 2005, and then to work on further convergence in the medium term. A Memorandum of Understanding of 2006 set out specific goals and priorities for further convergence. Section 8.9 looks at the differences currently remaining. As explained in Chapter 5, for a few years from 2008 it seemed that the SEC might adopt IFRS in the United States. However, it is now clear that the SEC will continue to let the FASB write GAAP for many years to come.

Miller *et al*. (1998) examine the operations of the FASB. Zeff (1995) analyzes the mix of public and private-sector regulation in the United States.

8.3.3 Influential parties

Particularly in the United States, there is substantial influence on standard-setting from representatives of the users of financial statements. The CFA Institute (formerly the Association for Investment Management and Research) is consulted and listened to by the FASB. One of the Board members of the FASB is a financial analyst by training.

Naturally, a major influence on standard-setting comes from the management of large companies (the 'preparers'). It has been suggested (e.g. Watts and Zimmerman, 1978) that they will lobby the FASB on the basis of their personal interests (e.g. in trying to support a company's share price). Presumably, lobbying of senators and others explains the intervention of Congress (see Sections 8.2 and 8.6, and Chapter 10).

Academics have also played an important role. Usually, one of the Board members is a former academic, and individual academics are frequently commissioned by the FASB to conduct research on issues under discussion. The organization representing academic accountants, the American Accounting Association, comments on exposure drafts.

8.3.4 Enforcement

As already noted, the FASB's standards are officially recognized in the United States as authoritative by the SEC. Further assurance of the enforcement of FASB standards is provided by the AICPA rules. It was noted above that membership of the AICPA is not

a prerequisite of the right to practise. However, state authorities that control the right to practise have generally adopted the AICPA rules. Rule 203 of the AICPA's Code of Professional Ethics states:

> A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the [FASB] . . . which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principles would result in a misleading statement.

The AICPA's Rules of Conduct also provide that:

> the Trial Board may, after a hearing, admonish, suspend, or expel a member [of the AICPA] who is found guilty of infringing . . . any provisions of the Rules of conduct'

Accordingly, a Certified Public Accountant who condones a departure from an FASB pronouncement is subject to loss of his or her standing in the profession and, assuming that the licensing authorities concur with the conclusions of the AICPA Trial Board, loss of his or her legal authority to attest to the fairness of an enterprise's financial statement presentation.

As noted earlier, SFAS 162 (now part of the ASC) does not allow departures on the grounds of fair presentation. The ASC is addressed to company management, whereas Rule 203 is addressed to auditors.

Section 8.8 examines US audit further. Chapter 20 looks, in a comparative international way, at enforcement of rules on listed companies.

8.4 The conceptual framework

8.4.1 Introduction

As noted above, the need for a conceptual framework was one of the primary considerations in the studies that led to the establishment of the FASB. There had been some previous work in this area. Several early accounting academics constructed frameworks of ideas (e.g. Paton, 1922; Canning, 1929; MacNeal 1939). In 1959, when the AICPA set up the APB, it also established an Accounting Research Division. The latter wrote[2] Accounting Research Study No. 1 (*The Basic Postulates of Accounting*) in 1961 and Accounting Research Study No. 3 (*A Tentative Set of Broad Accounting Principles for Business Enterprises*) in 1962. These documents contained definitions (e.g. of asset and liability) and a series of 'postulates', which mixed concepts (e.g. the entity and going concern) with desirable qualities of accounting information (in particular, objectivity and consistency, as postulates 2 and 3 on pages 41–3). However, Studies 1

[2]The documents were published by the AICPA, but the Director of Accounting Research (Maurice Moonitz, an academic) notes that publication was 'under his authority'. The first was written by Moonitz; the second by Robert Sprouse (another academic) and re-drafted by Moonitz.

and 3 were rejected by the APB because some of their content was too different from existing practice, and the APB eventually produced its own, mostly descriptive, set of principles as *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (APB Statement No. 4) in 1970. Chapter 4 of that deals with objectives, leading to a discussion of qualitative characteristics that gives primacy to relevance ahead of verifiability and neutrality (Schattke 1972, page 238).

Meanwhile, the American Accounting Association, the organization of academic accountants in the US, had published *A Statement of Basic Accounting Theory* (ASOBAT) in 1966 which was 'revolutionary' (Sterling 1967, page 95). It took a deductive approach rather than drawing on existing practice. ASOBAT was never accepted by the APB. Its conclusions appear strikingly modern. It put decision-usefulness at the top of its objectives for accounting (page 4), and set out (page 7) four 'basic standards'[3] for accounting information: relevance, verifiability, freedom from bias, and quantifiability. After that, there were five guides for communication: appropriateness to use, disclosure of significant relationships, inclusion of environmental information, uniformity of practice within and among entities, and consistency of practices through time. These desiderata would now be called 'qualitative characteristics'. Many of them are to be seen in the later frameworks of the FASB and the IASB.

The FASB devoted a significant portion of its early resources to the development of its 'Conceptual Framework for Financial Accounting and Reporting'. The Trueblood Committee (see 8.3.1 above) made an important contribution to the development of the FASB's first concepts statement, on the objectives of financial reporting. One of the documents issued by the FASB (1976) explains the significance of the framework:

> Though many organizations, committees, and individuals have published their own constructs of conceptual framework or aspects of a framework, none by itself has come to be universally accepted and relied on in practice. Notable among those efforts is Accounting Principles Board Statement No. 4 'Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises' (1970), but it purports primarily to describe the way things are and not to prescribe how they ought to be.
>
> A conceptual framework is a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function and limits of financial accounting and financial statements. The objectives are to identify the goals and purposes of accounting. The fundamentals are the underlying concepts of accounting, concepts that guide the selection of events to be accounted for, the measurement of those events, and the means of summarizing and communicating them to interested parties.

The FASB worked on the framework continuously for a decade after its formation. The Board's conclusions were originally issued as five concepts statements as follows:

- *Concepts Statement No. 1* described the fundamental objectives of financial reporting for business enterprises; a separate statement (No. 4) gives the objectives for non-business organizations.
- *Concepts Statement No. 2* described the qualities that make accounting information useful.

[3]The word 'standards' in its current meaning appears to have originated in the UK with the foundation of the Accounting Standards Steering Committee in 1969 (Rutherford, 2007, page 37).

- *Concepts Statement No. 3*, later superseded by No. 6, gives definitions for the main elements of financial statements: components such as assets, liabilities, revenues and expenses.
- *Concepts Statement No. 5* deals with criteria for recognizing and measuring the elements of financial statements, and with some of the issues that arise in relation to the presentation of information in financial reports.

In 2000, the FASB added to the framework by issuing Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. This helps to bring the framework up to date and is part of the process of moving away from costs and towards values for certain balance sheet items.

In 2010, the FASB issued Concepts Statement No. 8 (CON 8) as a replacement for Statements 1 and 2. This was done jointly with the IASB, and the new content of these parts of the framework is examined in Chapter 6. The FASB have not joined the IASB in further revisions since 2010. So, if the IASB's proposals in its 2015 exposure draft go ahead, some differences from CON 8 will occur.

However, it is not clear whether the conceptual framework helps to force the FASB to particular conclusions in any topic area. For example, discussions about standards involve the assessment of the benefits and costs of accounting alternatives and that assessment continues to be partly subjective because of conflicts of interest and the lack of firm evidence about the level of both costs and benefits. Many papers have suggested various limitations of the framework and its use (e.g. Dopuch and Sunder, 1980; Ketz and Kunitake, 1988; DePree, 1989; Mozes, 1998).

The FASB's framework has been influential around the world. For example, the IASB's Framework (see Chapter 6) and the UK's Statement of Principles clearly derive from it. The broad conclusions of Statement 6 are examined below.

8.4.2 Elements of financial statements

Statement 6 defines ten elements of financial statements, the main ones being assets, liabilities, equity, revenues and expenses. The other definitions rest upon 'asset' and 'liability'. An asset is defined as:

> probable future economic benefits obtained or controlled . . . as a result of past transactions or events.

A liability is:

> probable future sacrifices of economic benefits arising from present obligations . . . to transfer assets or provide resources to other entities in the future as a result of past transactions or events.

Equity is the difference between assets and liabilities; and revenues and expenses are defined in terms of increases and decreases in assets and liabilities. All this formed the basis of the equivalent content of the IASB's *Framework*. There is, however, an interesting difference in terminology. The FASB concentrates on 'revenues' and 'expenses', which are a smaller set of things than the IASB's 'income' and 'expenses'. The FASB's concepts are particularly related to an entity's 'ongoing major or central operations'. The IASB's 'income' and 'expenses' include other types of gains and losses.

As noted in Section 8.4.1, use of the framework has limitations. The FASB does not always follow its framework, or may take many years to bring standards into line with it. For example, SFAS 150 of 2003 eventually required mandatorily redeemable preference shares to be classified as liabilities even though they had always met the definition, as IAS 32 concluded in 1994. Convertible debentures are still generally classified as debt, even though they have an equity element that IAS 32 requires to be shown separately. Another example of very slow application of the definitions relates to lease accounting (see 8.6.2).

8.5 Contents of annual reports

8.5.1 Introduction

As explained in Section 8.2.2, the SEC requires a number of reports at various frequencies. A company must also file its financial statements (see below) and notes with its Form 10-K. There is also a requirement for 'Management's Discussion and Analysis' which explains the company's results and financial condition.

There are four annual financial statements for a US corporation: the balance sheet, the statement of comprehensive income, the statement of changes in equity and the statement of cash flows. Tables 8.2 and 8.3 illustrate the titles of the first two of these, as used by 500 large US corporations, drawing on surveys of US practice (e.g. AICPA,

Table 8.2 US terms for 'balance sheet'

		% of companies
Balance sheet		95.2
Statement of financial position		4.8
	Total	100.0

Source: American Institute of Certified Public Accountants (2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 147.

Table 8.3 US terms for the statement of performance

	% of companies	2000	2009
Operations statement*		33.0	48.4
Income statement*		47.3	36.2
Earnings statement*		18.0	14.0
Other		1.7	1.4
	Total	100.0	100.0

Note: *Or statement of income, etc.
Source: American Institute of Certified Public Accountants (2001/2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 311 (2001), p. 317 (2010).

2010). As may be seen, the term 'income statement' is gradually being replaced in the United States. Ironically, this coincided with the move of IFRS to that term and away from the UK term 'profit and loss account'. Unfortunately, the most recent surveys contain only examples from company reports rather than summary data such as in Table 8.2 and several other tables below. So, these tables cannot be up-dated for the latest periods.

8.5.2 Balance sheet

There are some standard elements of US balance sheets: for example, assets are shown at the top of a vertical balance sheet (or on the left of a two-sided balance sheet). Unlike the format under European (including UK) national laws, current assets precede fixed assets. Only a small proportion of US corporations use a 'financial position' format that shows net assets. This contrasts with UK practice under IFRS (see Chapter 7) and with the standard UK Format 1 in UK law (see Chapter 15), and so US formats are not especially well adapted for reading by non-technical shareholders.

The variety of terminology used can be further illustrated by looking at the equivalent of the UK term 'shareholders' funds'. In the United States, many different expressions are used, as demonstrated in Table 8.4. A further example is the remarkable diversity of terms (shown in Table 8.5) for the standard UK expression 'share premium'.

8.5.3 Changes in equity, including comprehensive income

Until recently, income statements in US GAAP and in all other systems of accounting did not show all gains and losses. For example, currency gains and losses on translation of financial statements into the parent's functional currency (see Chapter 17) were shown as reserve movements. The accounting system of the UK was the first to require entities to show all gains and losses in statements of income: in 1993, FRS 3 required a separate 'statement of total recognized gains and losses' to show any

Table 8.4 US titles for 'shareholders' funds'

		% of companies
Stockholders' equity		51.2
Shareholders' equity		35.8
Shareowners' equity		3.2
Shareholders' investment		1.0
Common stockholders' equity		1.0
Common shareholders' equity		0.2
Deficit or deficiency		4.4
Other or no title		3.2
	Total	100.0

Source: American Institute of Certified Public Accountants (2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 300.

Table 8.5 US expressions for UK 'share premium'

		% of companies
Additional paid-in capital		57.0
Capital in excess of par or stated value		15.2
Paid-in capital		10.2
Additional capital or other capital		2.8
Capital surplus		2.4
Other captions		2.8
	Sub-total	90.4
No additional paid-in capital account		9.6
	Total	100.0

Source: American Institute of Certified Public Accountants (2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 302.

amounts excluded from the profit and loss account (see Chapter 15). In 1997, SFAS 130 introduced the requirement for entities to present a statement of changes in equity. This shows information on OCI, which includes the above type of currency items and gains on the revaluation of investments that have not yet been included in net income (see Section 8.6.4). The statement also includes other causes of changing equity, such as share issues or dividend payments. Entities were allowed to show OCI in a separate statement or in the income statement, but that was rare. It is clear that managers prefer investors to concentrate on a profit number that excludes large volatile elements. Bamber *et al.* (2010) discovered that this particularly applies in US firms whose managers have equity-based compensation or little job security.

The IASC introduced something similar into IAS 1 in 1997, allowing either the US approach (a statement of all changes in equity) or the UK approach (a statement containing the gains and losses excluded from the conventional income statement). From 2013, both IFRS and US GAAP require a complete statement of changes in equity, and both require OCI to be shown as income (see immediately below).

8.5.4 Statement of income

From 2013, both US GAAP and IFRS apparently require a single statement containing profit or loss and OCI. However, they can be shown as separate sections; and, in practice, nearly all companies show two statements.

An important international difference remains: the treatment of any gain or loss on realization (e.g. on the sale of a foreign subsidiary). In other words, on disposal, is a gain that was previously recorded as OCI re-classified as profit or loss and a reduction in OCI? Table 8.6 shows three different answers for the US and IFRS. The origin of the inconsistent approach of IFRS is that gains/losses were never re-classified in the UK. Clearly, this issue needs to be addressed by the standard-setters but, despite large numbers of working parties from the late 1990s onwards, no conclusion has been reached even in the joint FASB/IASB *Preliminary Views on Financial Statement Presentation* of 2008. The issue is examined further in Chapter 9 (Section 9.10).

Table 8.6 Are gains or losses that were previously recorded as OCI later re-classified as profit or loss?

	US	IFRS
Revaluation of financial assets	Yes	Yes
Revaluation of tangible assets	N/A	No
Translation of foreign statements	Yes	Yes
Actuarial gains/losses	Yes	No

N/A = Not applicable because practice not allowed.

US income statements tend to be somewhat more detailed than those in other countries. Their titles vary, as already shown in Table 8.3. A further difference from nearly all other countries and from IFRS is that three years of figures are presented; that is, the two preceding years' comparative figures. This is an SEC requirement, and will still apply to US corporations presenting IFRS statements.

8.5.5 Statement of cash flows

The statement of cash flows is required by SEC Regulations, but is a more recent arrival than the other two main statements. It is not part of the double-entry system but, as its name suggests, is another way of looking at some of the information in the balance sheet and income statement. Such a statement is also required by IAS 7 and in the United Kingdom (by FRS 1 and now FRS 102), but it was uncommon in much of continental Europe before the use of IFRS. As with the income statement, the US rules are unusual in requiring three years' figures.

Until 1987, the US requirement had been for a 'statement of changes in financial position', but this was replaced (in SFAS 95) by the statement of cash flows, which concentrates on movements in cash and cash equivalents rather than on a more general notion of 'funds'. The FASB/IASB *Preliminary Views* (referred to above) proposed to move to an even narrower focus of 'cash', as has been used in the UK's cash flow statement. However, at the time of writing (mid-2015), this has not yet happened. There are three main headings in the statement: 'operating', 'investing' and 'financing'. The statements generally start with post-tax profit, and so tax is not shown as a use of cash.

US GAAP has less flexibility than IAS 7 about where to show interest and dividends paid and received. In US GAAP, they are all 'operating' except for dividends paid which are 'financing'.

8.5.6 Technical terms

Table 8.7 gives several examples of US/IFRS/UK differences in terminology. In many cases, these are fairly harmless. For example, most non-American speakers of English can easily understand terms such as 'accounts receivable', 'accounts payable' or 'sales'. However, in some cases, confusion is possible. For example:

- The British Companies Act's term for 'sales' is 'turnover'. However, 'turnover' would be interpreted in the US as departure and hiring of staff.

Table 8.7 Some US, IFRS and UK accounting terms

United States	IFRS	United Kingdom*
Accounts payable	Payables	Creditors
Accounts receivable	Receivables	Debtors
Allowance (e.g. doubtful debts)	Impairment	Provision (term in the Act)
Balance sheet	Statement of financial position	Balance sheet
Bylaws	–	Articles of association
Capital lease	Finance lease	Finance lease
Capital surplus	–	Share premium
Certificate of incorporation	–	Memorandum of association
Common stock	Ordinary shares	Ordinary shares
Constant dollar accounting	–	Current purchasing power
Current rate method	–	Closing rate method
Fiscal year	Accounting period	Financial year
General price level adjusted	–	Current purchasing power
Income	Profit	Profit
Income (or operations) statement	Income statement	Profit and loss account
Inventories	Inventories	Stocks
Leverage	–	Gearing
Notes	–	Bills
Paid-in surplus	–	Share premium
Par value	Par value	Nominal value
Pooling of interests	Uniting of interests	Merger accounting
Preferred stock	Preference shares	Preference shares
Property, plant and equipment	Property, plant and equipment	Tangible fixed assets
Purchase accounting	Purchase accounting	Acquisition accounting
Real estate	Land	Land
Reserve (e.g. doubtful debts)	Impairment	Provision (in the Act)
Reserve (e.g. pensions)	Provision	Provision
Sales	Revenue	Turnover
Stock	Shares	Shares
Stock-based compensation	Share-based payment	Share-based payment
Stock dividend	Bonus issue (small)	Bonus issue (small)
Stockholders' equity	Equity	Shareholders' funds
Stock split	Bonus issue (large)	Bonus issue (large)
Treasury stock	Treasury shares	Own shares

Note: *Terms used in the Companies Act and in UK law or in UK standards until 2014, when they were revised.

- The most usual meanings of the UK terms 'stock' and 'shares' are translated into the US terms 'inventory' and 'stock' respectively. It would be unwise, therefore, to try to discuss with an American the use of FIFO for *stock* valuation. IFRS tries to avoid the confusion by using 'inventory' and 'shares'. Worse than this, the expression 'treasury stock' would be taken to mean gilt-edged (i.e. government) loan securities in the United Kingdom, whereas in the United States it means a corporation's own shares bought back and held in the corporate treasury. The IFRS term for such shares is a compromise: 'treasury shares'.

- Some words, such as 'property', have subtly different meanings when they cross the Atlantic. In the United Kingdom, 'property' usually means land (i.e. *real* estate or *real* property) and buildings. In the United States, 'property' can have a wider meaning, encompassing any tangible fixed asset.
- Severe difficulties with the words 'provision', 'reserve' and 'allowance' occur, as noted earlier in Section 2.9.

8.6 Accounting principles

8.6.1 Property, plant and equipment (PPE)

North American accounting practices reflect a long-standing adherence to historical cost. Zeff (2007) traces the SEC's rules on historical cost from 1934 to the 1970s. In US GAAP, there is also the related notion that revenues and gains are recognized only when an objective 'arm's length' transaction with another party has occurred. Accordingly, the financial statement carrying values of property, plant and equipment or intangible assets are not increased on the basis of upward appraisals or changes in prices because those events are not 'transactions'. This is unlike IFRS, which gives permission for revaluations in IASs 16 and 40, and requires them for certain 'biological assets' in IAS 41. However, US GAAP (and IFRS) do now depart from the cost principle for financial assets (see Section 8.6.4).

The 'cost' of assets that have been constructed by a company for its own use must include 'borrowing costs', i.e. the interest cost or money borrowed to finance the project. This capitalization of interest cost is also required by IAS 23 (from 2009) but is not required (and in some cases not allowed) by most national rules (e.g. those of France, Germany or the UK).

It is universal practice in North America to allocate the cost of tangible fixed assets over their useful lives. Paragraph 5 of Accounting Research Bulletin (ARB) No. 43, Chapter 9C (ASC 360-10-35-4), states the position in the United States:

> The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is process of allocation, not of valuation.

It is important to emphasize that there are no exceptions to this rule as there is, for example, in IFRS for investment properties.

As in most countries, several methods are accepted for the computation of depreciation. The straight-line method is most common, but various methods of providing accelerated charges are also accepted including the reducing balance method and the sum-of-the-years'-digits method.

There are also rules on impairment of assets, introduced by SFASs 121 and 144, and now in ASC 360-10-35-15. These require that assets should be examined at each balance sheet date (i.e. quarterly for SEC-registrants) for any indication of impairment (e.g. physical damage). If there is such an indication, a calculation must be made to compare: (i) an asset's carrying value, with (ii) the sum of the expected future cash flows from the use and sale of the asset (undiscounted and without interest charges). If (ii) is lower than (i), then an impairment loss should be recognized. The loss is measured as the excess of the carrying amount over the fair value.

The term 'fair value' means the amount that willing buyers and sellers would exchange the asset for, in an arm's length transaction. If there is no market, the impairment loss is measured by reference to discounted cash flows as an estimate of fair value.

By contrast, IAS 36 has no test of impairment using undiscounted cash flows. If there is an indication of impairment, its size is measured by comparing carrying value with the higher of a market value and value in use (i.e. discounted cash flows). This means that more impairments will be recorded under IFRS, because many of them are filtered out by the use of undiscounted (i.e. higher) cash flow totals under US rules.

For example, suppose the following facts about a used and damaged machine:

- carrying value (depreciated cost) = $9 million
- fair value (less any costs to sell) = $6 million
- undiscounted net cash flows = $11 million
- value in use (discounted net cash flows) = $8 million

Under US GAAP, there is no impairment because the expected cash flows ($11 million) exceed the carrying amount ($9 million). However, under IFRS, there is an impairment of $1 million because the recoverable amount (the higher of value in use and fair value) is only $8 million.

A further important point relates to reversals of impairment. Given that impairments involve much judgement, some impairments turn out to be pessimistic. However, US GAAP does not allow the reversal of impairments, because this might lead to deliberate over-impairing followed by later reversals, designed to smooth the presentation of earnings. By contrast, IFRS requires the reversal of impairments that are discovered to be excessive, except those relating to goodwill.

8.6.2 Leases

For nearly 70 years the United States has had accounting requirements dealing with leasing arrangements. They began in 1949 with a relatively simple requirement that lessees should (a) disclose the amounts and timing of annual rental payments and (b) assess whether certain leases might be considered a capitalizable asset. This evolved into a comprehensive, sometimes complex, network of accounting and reporting criteria related to leasing activities from the perspectives of both the lessee and the lessor.

Despite the complexity, the concept is simple: if the risks and rewards associated with ownership of the leased asset accrue to the lessee, the lessor reports the signing

of the lease as a sale of that asset (sales-type or direct financing lease), while the lessee reports it as a purchase. This is a 'capital lease'. Otherwise, both the lessee and the lessor report the lease as an 'operating lease'. The practical dividing line between capital and operating leases is set arbitrarily. One threshold for a capital lease is 75 per cent of useful life, another is that it involves at least 90 per cent of the asset value. By contrast, the IASB's equivalent standard (IAS 17) makes no reference to these numerical thresholds, relying only on the idea of transfer of 'substantially all the risks and rewards' to the lessee. This is a good illustration of a US rule contrasted to an IASB principle.

The idea that a lease should be a basis for reporting both an asset and a liability of equal amounts is designed to reflect 'substance over form', i.e. the economic reality (that the lessee has use of most of the asset) rather than the legal formality (that the lessee does not own the asset). However, this itself can be a misleading way to look at the issue, because the economic substance depends on the exact legal arrangements.

In the United States, the use of leasing agreements as a financial mechanism grew very rapidly. In certain industries (such as the manufacture of photocopiers or computers) 'leasing' overtook the traditional 'sale' as a means of marketing finished products. Because lessors know that lessee companies do not like to capitalize leases, particularly because of the liabilities that are then recognized, leases are often arranged to avoid meeting the technical criteria for being treated as capital leases. The FASB and the IASB therefore decided to require all non-cancellable leases to be treated as capital leases, given that the definitions of 'asset' and 'liability' seem to be satisfied (see Section 6.2). This was unpopular with lessors (see Section 10.7).

In 2010, the FASB issued a joint exposure draft with the IASB, proposing largely to abolish the concept of operating leases. However, this met difficulties, and amended drafts were issued in 2011, with rather different FASB and IASB versions, though both requiring lessees to treat most leases as capital leases in balance sheets. US GAAP was amended in 2016 along these lines. For lessors, however, some leases (e.g. most leases of property) continue to be treated like operating leases. Barone *et al*. (2014) examine the academic literature on the economic implications of the various proposals for lease accounting. For example, capitalization increases liabilities and therefore gearing ratios, which might affect the decisions of a lessee's lenders.

8.6.3 Intangible assets

In general in US GAAP, the cost of intangibles must be recognized as assets if purchased, but treated as expenses if internally-generated. Consequently, research and development costs are treated as expense immediately, unless of course they create physical fixed assets such as a laboratory. SFAS 2, the original standard, discussed the conflict between *prudence* (which would require the amounts to be treated as expense at once) and *accruals* (which suggests that the expense should be carried forward for matching). However, it concluded that, on balance, prudence and a desire for uniformity call for a straightforward prohibition on capitalization. A specific exception concerns computer software. GAAP requires the costs of developing this to be capitalized under certain conditions when the technological feasibility of the product has been established. The US requirements are more conservative than the IFRS rule

(in IAS 38), which requires development costs to be capitalized when they meet certain criteria (see more detail in Chapter 9).

The general measurement requirements on intangible assets are similar to those for PPE. Most obviously, such assets must be valued at historical cost and, if they have identifiable useful lives, amortized over those lives. APB Opinion 17 had limited the useful life to 40 years, but this limit was removed by SFAS 142 in 2001 (now ASC 350-30-35). Now, an intangible asset with a finite life must be amortized over that life. However, intangibles with indefinite lives (including any goodwill) must not be amortized but are subject to an impairment regime. Once a year, an assessment must be made of each such intangible to see if an impairment calculation (as in 8.6.1 above) would be likely to show an impairment. If it would, and impairment calculation must be done. Alternatively, each such intangible must be tested for impairment annually, without the initial assessment. This latter treatment is required under IFRS.

8.6.4 Investments

The use of a current/non-current distinction is not required in the United States, although many companies present their balance sheets classified in this way. For *measurement* purposes, GAAP ignores this distinction and requires investments to be split into three types, based largely on management intentions:

1 *held-to-maturity:* measure at amortized cost;
2 *trading (including derivatives):* measure at fair value;
3 any others, called *available-for-sale*: measure at fair value.

Treatments 2 and 3 will lead to unsettled gains and losses. These should be taken to income for item 2, and to other comprehensive income for item 3. The treatment of item 2 (i.e. fair value with gains to income) is called 'marking to market'. It is restricted to marketable securities in US GAAP, whereas it even applies to unlisted investments under IFRS. Marking to market also applies to any trading liabilities. SFAS 157 defined fair value as the current market price for disposing of an asset or liability, without deducting any costs of disposal (now ASC 820-10-05).

For *disclosure* purposes, GAAP requires fair value information for many of the investments measured at cost. There is a similar requirement in IFRS 7. By contrast, in the domestic rules of most countries there are no systematic disclosures of fair value; fixed asset investments are generally held at cost, and current asset investments are generally accounted for at the lower of cost and net realizable value, although financial institutions tend to hold marketable securities at market value.

8.6.5 Inventories

The general rules for the valuation of inventory (now ASC 330-10) are based on the very old ARB 43. The almost universal rule of 'the lower of cost and market' is used in the United States. However, 'market' normally meant replacement cost in the United States, whereas it means net realizable value to the IASB. In 2016, US GAAP became like IFRS for most inventories. Once an inventory has been reduced from cost to market, the impairment cannot be reversed if the market rises. This, again, is unlike IFRS practice.

Table 8.8 **Cost determination for inventory valuation, for 500 companies**

	Instances of use
FIFO	325
LIFO	176
Average cost	147
Other	18
	Companies
Use of LIFO by the 176 companies above:	
For all inventories	4
For 50% or more	82
For less than 50%	78
Not determinable	12
Companies using LIFO	176

Note: This table shows methods used by 500 large companies. A company may use more than one method.
Source: American Institute of Certified Public Accountants (2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 169.

The major interesting feature of US inventory valuation is that many companies use the LIFO method of determining the cost of inventory (see Table 8.8). The use of LIFO means that the most recently purchased inventory is deemed for accounting purposes to be the earliest to be used up in production or sales, leaving the oldest inventory to be included in the closing inventory at the year end. When the price of a particular type of inventory is rising, this means that income is lower and closing inventory is also lower than it would be when using the alternative methods of average cost or FIFO.

LIFO was originally allowed for tax purposes in the United States in order to act as a relief from the taxation of inventory holding gains when prices rise. Otherwise, tax would have to be paid on income that is tied up in the extra value (despite a constant volume) of inventory. The problem for US accounting is that the tax rules require companies to use LIFO for the published income statement if it is used for tax purposes. This is reminiscent of the more general effect of tax rules on accounting in some continental European countries (see Chapter 2).

As has been mentioned, many US companies take advantage of the tax reductions made possible by the use of LIFO. However, as Table 8.8 shows, most companies actually use a mixture of methods, presumably because some inventories fall in price and some are non-LIFO inventories of foreign subsidiaries. Those companies still using FIFO may be doing so in order to keep profits up, perhaps because management compensation is linked to declared net income. A considerable amount of empirical research (e.g. Jennings *et al.*, 1992; Hunt *et al.*, 1996) has been carried out but has not been able to resolve whether the market can see through LIFO's disadvantageous effect on earnings to the advantageous effect on

tax payments. The rule requiring consistent application of GAAP stops frequent changes from LIFO to FIFO and back.

The effects of the use of LIFO can be very great. As far as the valuation of closing inventory is concerned, the prices involved can be *decades* old, not just slightly out of date. That is, LIFO retains costs of inventory from whenever that type of inventory was first bought. Thus, closing inventory valuations may be *very* unrealistically low. This might be more serious than out-of-date fixed asset valuations because inventory is nearer to being sold and it forms a major element in liquidity ratios. Even worse, when inventories are physically reduced, perhaps because production shifts to the use of a more modern material, very old costs of inventory may pass through the income statement. This is sometimes called 'eating into old LIFO layers of inventory'. This can lead to misleadingly high income, although it could be claimed that LIFO normally gives a better picture of income because cost of sales includes more current costs.

GAAP requires companies to disclose which method of inventory costing is being used, and the SEC requires its registrant companies that use LIFO to disclose in the notes what the value of inventory would have been using FIFO. There are two examples of companies in Table 8.9. In the case of Caterpillar in 2010, inventory would have been 27 per cent higher if FIFO had been chosen as the basis of valuation. This difference was very significant in the context of net current assets (26 per cent) and net assets (24 per cent). So, important ratios, such as liquidity and return on net assets and gearing/leverage, are seriously affected.

The use of LIFO is one of the largest differences, in terms of millions of dollars, between US and IFRS accounting. The IASB banned LIFO in 2003 on the grounds that it is unlikely to give a fair presentation of closing inventory. There would be a political problem with trying to ban LIFO in the United States because it is only allowed for the purposes of taxation if it is used in the income statement. By contrast, for example, LIFO is not acceptable for tax purposes in the United Kingdom, which made it possible for SSAP 9 to generally ban it from the 1970s for accounting purposes. Unless US tax rules could be changed, the adoption of IFRS by US companies that use LIFO would lead to tax increases.

8.6.6 Employee benefits, including stock-based compensation

One of the largest liabilities in the balance sheets of many US companies relates to employee benefits. Some US companies promise not only pension benefits, but also

Table 8.9 Adjustments from LIFO to FIFO

	LIFO ($m)	Adjustment ($m)	FIFO ($m)	% Increase
Ford (2010)	5,917	865	6,782	15
Ford (2014)	7,866	978	8,844	12
Caterpillar (2010)	9,587	2,575	12,162	27
Caterpillar (2014)	12,205	2,430	14,635	20

post-retirement medical benefits. Such obligations must be accounted for at the discounted value of expected payments. An interesting case study on this relates to General Motors before it had to seek protection from its creditors in 2008. In the 2007 balance sheet, General Motors has $11.4bn of pension liability and $47.4bn of medical liability. This was the major explanation for a balance of equity of minus $37.1bn. This example is taken further in Chapter 9.

Complications in pension accounting arise when the estimates change, giving rise to actuarial gains and losses. Treatment of these has been controversial, and a new US standard (SFAS 158) was issued in 2006. The main point is that actuarial gains and losses must now be recognized immediately in the balance sheet, whereas they had not been before. Small changes are recognized immediately in profit or loss, but larger ones are initially recorded as OCI and taken gradually to profit or loss. These matters are discussed in detail in Chapter 9, where there is also a comparison with IFRS.

Another way of remunerating employees beyond their salaries is to make grants (or promises of grants) of shares (or options to buy shares). This practice began in the United States and is still most widespread there. Let us take a typical example. Suppose that Company X grants an option to Employee Y, on 1 January 2017, to buy 1,000 shares in Company X at $5 per share on 31 December 2018 (or within a period starting on that date) if the employee is still working for the company on that date. On the grant date, the share price is $5.

One view is that the options are not worth anything (i.e. have no 'intrinsic value'), at least not when granted. However, they would have a *market* (fair) value because the least they can yield to the employee is zero, and they will become valuable if the share price is above $5 by the end of 2018.

Accounting on this basis requires an estimation of the fair value of the options on the grant date. This amount is treated as an employee expense (and a credit to equity) over the two-year period. The management of companies would prefer to avoid recognizing this expense. The FASB's predecessor (the APB) issued Opinion 25, which required only disclosure of fair value. When the FASB itself tried to issue a fair value standard, it was beaten into submission by companies and Congress (see Chapter 10), such that SFAS 123 also originally allowed disclosure only. In 2004, the FASB revised SFAS 123 in order to require accounting for the fair value of stock options, but again this led to political action and postponement of the standard until 2006 when it eventually came into force (now ASC 718-20). This is similar to the IASB's IFRS 2 that had come into force in 2005.

For a review of the theoretical issues concerning share-based payments, see Mozes (1998) and Kirschenheiter *et al*. (2004).

8.6.7 Accounting for corporate taxes

It is well known that the income of a company, measured according to generally accepted accounting principles, normally differs under Anglo-Saxon accounting (including under IFRS) from the income on which taxes are payable. The most common reason for the difference is that various accelerated depreciation allowances are deductible in the computation of taxable income, regardless of the methods used to compute depreciation expense in the income statements. Consequently, when the

assets of a company are relatively new, or when a company is expanding or when prices are rising, its depreciation allowed for tax purposes will exceed the amount charged in the published income statement. Consequently, taxable income will be lower than reported income. The tax bill will then look too low, but that will be reversed in a later period. To correct for this, US GAAP invented 'inter-period tax allocation', i.e. making the 'tax expense' in the income statement fit the pre-tax profit. So, in the depreciation example, the tax expense would be made higher than the real cash tax bill. The difference was matched by a credit balance shown as a deferred tax liability in the balance sheet: a sort of postponed tax bill. This income statement view (see Section 8.4) can be seen in the early standard APB Opinion No. 11 of 1967, and then in the original IAS 12 of 1979, and SSAP 15 in the United Kingdom.

Another way of looking at this is that the asset is held at a different value for tax purposes compared with its value for accounting purposes. In the example of accelerated tax depreciation, the tax written-down value is lower than the accounting written-down value, which is regarded as creating a deferred tax liability, although it does not seem to meet the definition of a liability (see Section 9.8). The FASB adopted this balance sheet view in 1991 in SFAS 109. Then, IAS 12 (of 1996 onwards) also took this view, but the UK retained the income statement view (in FRS 19 of 2000) until 2014.

Under any of these standards, account is taken of a change in corporate income tax rates, as this affects the size of any liability (the 'liability method'). In some other countries (and under the old APB Opinion 11), rate changes are ignored so that the rate used is that ruling when the timing/temporary difference originated (the 'deferral method').

After many changes, US GAAP and IFRS requirements on deferred tax are now largely the same: full accounting for temporary differences using the liability method. More detail on accounting for deferred tax is given in Chapter 9. For a US overview of the historical development of deferred tax accounting, see Schultz and Johnson (1998).

8.7 Consolidation

8.7.1 The scope of the group

American companies pioneered the concept of consolidation, as will be explained in Chapter 16. As for many other topics, US GAAP has tried to provide an auditable rule rather than a principle for the definition of those companies to be consolidated. The IASB's concepts of 'power to govern the financial and operating policies' (in IAS 27) and now 'the ability to use its power to affect the amount of the investor's returns' (in IFRS 10) are clear in principle, but need judgement in some cases. The US scope of consolidation (based on APB Opinion 18) rests on the ownership of more than half of the voting shares or on other legal arrangements to secure control (now ASC 810-10-15-10). This enables companies to engage in a series of devices to establish entities that are in practice controlled but fall outside the scope to be consolidated. These 'special purpose vehicles' (SPVs) can then contain unconsolidated borrowings and other forms of off-balance sheet finance. The most spectacular example of this was

the energy trading company, Enron, which had thousands of such SPVs when it collapsed in 2001/2, taking its adviser/auditor (Andersen) with it.

The Sarbanes-Oxley Act of 2002 responded by requiring footnote disclosure of off-balance sheet liabilities. The FASB also issued Interpretation No. 46 in 2003 that requires consolidation of certain 'variable interest entities' (VIEs) that the group supports or receives residual returns from, even though they are not controlled (see Chapter 16). The investigation by the SEC and the FASB of the merits of principles-based standards (see Section 8.3) is also related to this.

8.7.2 Accounting for business combinations

A detailed discussion of practice on the preparation of consolidated statements and on the alternative methods of accounting for mergers and acquisitions is given in Chapter 16. US accounting practices related to business combinations were determined until 2001 on the basis of APB Opinion 16, Business Combinations. That Opinion provided for the use of two methods of accounting: the 'purchase method' and the 'pooling of interests method'.

Under the purchase method, the measurement basis for the acquired enterprise's assets in the group financial statements is their fair value at the time of the business combination. Paragraph 11 of APB Opinion 16 described the essence of the purchase method, as follows:

> The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation.

Under the pooling of interests method, the measurement basis of the acquired enterprise remained unchanged, and the depreciated historical cost of its assets was combined with that of the acquiring enterprise's assets. Poolings were abolished in US GAAP from 2001. So all combinations from then have been treated as purchases, although previous poolings remain in place, and therefore still affect the financial statements of some large groups. The topic is examined further in Chapter 16, including an IFRS comparison.

8.7.3 Goodwill

There have been major international differences in the calculation and treatment of goodwill. Under US and IASB rules, goodwill is now calculated as the difference between the fair value of the consideration and the fair value of the net assets acquired. However, there was a major practical difference in that the United States required (until 2009 statements for most companies) the use of the acquirer's perspective whereas IFRS 3 takes a neutral or market perspective. The acquirer's perspective involved recognizing provisions for proposed restructurings, which wrote down the net assets and increased goodwill. This reduced subsequent depreciation of assets, increased the recorded gains on sale of assets and absorbed various future expenses.

Now, such expenses are charged in income statements after the combination. A further change in 2009 (and to IFRS) is that the expenses of the combination, such as lawyers' and bankers' fees, are charged immediately to the income statement rather than being added to the cost of acquisition (and therefore increasing goodwill). A numerical illustration of this is shown in Section 16.7.

Another former difference (again, generally until 2009) was that negative goodwill did not often arise in the US because the acquired non-monetary assets were written down pro rata to avoid it, whereas now (as under IFRS) negative goodwill is treated as immediate income.

The more general international difference concerns the treatment of positive goodwill. A brief outline of changes to US, UK and IASB rules reveals some of the remarkably different possibilities. US practice, under APB Opinion 17 until 2001, was to treat goodwill as an asset and to amortize it over its useful economic life (not exceeding 40 years). Many companies used 40 years, given the difficulty of estimating the life of goodwill and that this choice slowed down the expense as much as possible. However, the SEC frequently required a shorter period to be used by companies in particular sectors. By contrast, majority UK practice ('preferred' by SSAP 22) was (until 1998) was to deduct goodwill immediately from group reserves. This meant that US group assets looked larger than they would have under UK practice, and US group income looked smaller. It has been suggested that this led to a comparative international disadvantage for acquisitive US managements (Choi and Lee, 1991).

The IASC had allowed the UK practice until 1995 but then required capitalization with a maximum of 20 years for amortization. However, at the end of the 1990s both the UK and the IASC moved to a requirement to capitalize and a rebuttable presumption of a 20-year maximum life. Any goodwill with a life in excess of 20 years had to be tested annually for impairment.

In 2001 the FASB took all this development to its logical conclusion by publishing SFAS 142, which abolished amortization, requiring instead annual impairment tests. The logic of this is that goodwill does not necessarily wear out, and the annual amortization expenses over an arbitrary life were meaningless numbers. Of course, the removal of this expense made the removal of poolings (which involved no goodwill, see above) more palatable. The IASB followed the FASB's approach of annual impairment tests for 2005 onwards.

However, impairment tests are laborious. So, from 2011, companies are allowed to avoid them if an assessment shows that an impairment test would not reveal the need for impairment. This option has not been followed by the IASB.

More details about US goodwill requirements can be found in Chapter 16.

8.8 Audit

The report of a company's independent auditors can be an important source of information for the reader of its financial report. It explains what the auditors have done to satisfy themselves as to the fairness of the financial statements. The report states an opinion regarding their fairness, given the context of generally accepted accounting principles. The standard form of the audit report in the United States is as follows:

> We have audited the accompanying Consolidated Balance Sheets of XYZ Company and subsidiaries (the Corporation) as of December 31, 2015 and 2014, and the related Consolidated Statements of Income, Cash Flows, and Stockholders' Equity for each of the three years in the period ended December 31, 2015. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits.
>
> We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of XYZ Company and subsidiaries at December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

The key words in the opinion in the last paragraph are 'present fairly . . . in conformity with accounting principles generally accepted'. The reference to GAAP reflects a reliance on authoritative literature, including standards (see Zeff, 1990 and 1992).

In 2002, the US Congress passed the Sarbanes-Oxley Act (SOX), which requires senior management to certify the reliability of the financial statements and imposes greater independence requirements on auditors. SOX is not directly about accounting, except requiring some disclosures. It is mainly about corporate governance and audit. Its requirements are onerous and have made it more expensive to be registered with the SEC and listed on US exchanges. In 2003, the Public Company Accounting Oversight Board decided to set auditing standards itself rather than delegating this task to the AICPA, which had performed the role for over 60 years. Zeff (2003) examines how the US audit profession gradually fell from grace over a century.

As mentioned in Section 8.2.1, there is no compulsory audit for most US corporations, some of which therefore choose instead to have an 'audit review', which is a standardized set of procedures but less than a full audit.

8.9 Differences from IFRS

As mentioned in Chapter 5, nearly all major companies throughout the world are using either IFRS or US GAAP for consolidated reporting. Consequently, the differences between the two systems are of great importance for international comparisons.

The US and the IASB largely share the same conceptual framework. In particular, both see the primary purpose of financial reporting as the provision of useful information to investors for the prediction of future cash flows; and they have similar

definitions of 'asset' and 'liability', which are seen as the basic elements of financial statements. Furthermore, the FASB and the IASC collaborated on certain projects from the late 1990s onwards (e.g. IAS 14 (revised) on segment reporting, and IAS 33 on earnings per share). However, by the late 1990s, US GAAP and IFRS had clearly become rivals for worldwide domination of financial reporting. Consequently, the FASB was keen to point out the differences in the two systems and, by implication, the weaknesses of international standards (e.g. Bloomer, 1999).

There was a new dynamic from 2001. The SEC had signalled approval of the set up of the new IASB (see, for example, Camfferman and Zeff, 2007, chapter 13). Furthermore, the initial 14 members of the IASB included two former FASB members and one former FASB trustee. Then, the FASB got a new chairman in 2002 who had briefly been an IASB member. A formal convergence project was announced in 2002 and updated in 2006 and 2008. As a result, cooperation between the FASB and IASB became extensive, and all major new projects were undertaken jointly. Table 5.7 shows examples of cases where the FASB adopted IFRS requirements. The largest joint project led to a new standard on revenue recognition in 2014.

As noted earlier, the SEC accepted IFRS reports from foreign registrants from 2007, and even issued a proposal in 2008 to adopt IFRS generally. When, eventually, nothing came of this, the level of cooperation reduced from 2012.

One general difference from IFRS is that US GAAP is much more detailed ('rules-based') on many topics, as discussed in Chapter 5. A hindrance to the international use of US GAAP is that it is not available in languages other than English, whereas there are now official translations of IFRS into several languages. Chapter 5 also includes some examples of reconciliations from IFRS to US GAAP.

Table 8.10 shows some of the ways, in 2015, in which US rules would not allow or would not require conformity with IFRS. These are the issues that would affect companies wishing to convert from US GAAP to IFRS. Looking at it the other way round,

Table 8.10 Some ways in which US GAAP requires or allows different treatments from IFRS

- Fewer impairments are recognized under US GAAP because of a test involving undiscounted cash flows (see Section 8.6.1).
- Impairments cannot be reversed (see Section 8.6.1).
- Some compound financial instruments are not split into debt and equity components (see Section 8.4.2).
- Unlisted investments are generally valued at cost rather than at fair value (see Section 8.6.4).
- Inventories are reduced (when impaired) to current replacement cost (rather than to net realizable value) and the reduction cannot be reversed (see Section 8.6.5).
- The LIFO method is allowed (see Section 8.6.5).
- Development costs (except for software) cannot be capitalized (see Section 8.6.3).
- Some actuarial gains and losses are taken to profit or loss and some to OCI (with later re-classification to profit or loss) (see Section 8.6.6).
- Some enterprises that are de facto controlled are excluded from consolidation (see Section 8.7.1).
- Some VIEs which are not controlled are included in consolidation (Section 8.7.1).
- Goodwill can be assessed before having to test for impairment (Section 8.7.3).

Table 8.11 Some IFRS options not allowed under US rules

- More flexibility of balance sheet formats (see Section 8.5.2).
- Flexibility of presentation of financial cash flows (see Section 8.5.5).
- Valuing tangible and some intangible assets above cost (see Section 8.6.1).
- Measuring non-controlling interests at share of net assets (see Chapter 16).

there are many areas of US GAAP on which IFRS is less detailed or allows more options; Table 8.11 shows some examples of these. The differences were charted in detail in Nobes (2001) and more recently on the PWC website at: http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-and-us-gaap-similarities-and-differences.jhtml. Ernst & Young (2013) also examine them. Bellandi (2007) compares in detail the format and content of IFRS and US statements of financial position.

SUMMARY

- The US has no federal Companies Act but a powerful SEC. Private-sector standard-setting has supplied most of the content for generally accepted accounting principles. The body now setting standards is the FASB.
- The conceptual framework of the IASB is based on that of the FASB, which uses a balance sheet basis.
- There are large numbers of US/IFRS/UK differences in technical accounting terms.
- The US adheres to historical cost for tangible and intangible assets, with a different test of impairment from the IASB.
- The US invented the idea of capitalizing leases, and proposes to extend this further.
- Fair value accounting has been introduced for certain investments.
- LIFO is allowed and commonly practised for inventory valuation, which causes large reductions in balance sheet figures.
- The US method of fully accounting for deferred taxes on temporary differences was the model for the standard of the IASB.
- The pooling of interests method for accounting for business combinations was used more in the United States than in other countries, but it was banned in 2001.
- For decades, the US rule on the treatment of goodwill was that it should be capitalized and amortized over up to 40 years. In 2001, this changed to capitalization followed by impairment reviews.
- US rules are more extensive and detailed than those of the IASB, and there are some incompatibilities.

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Further reading

The accounting practices of US corporations are surveyed each year in AICPA (annual). The US GAAP requirements are summarized topic by topic in *GAAP Guide* (annual). The differences between US GAAP and IFRS are examined in detail by Ernst & Young (2013).

Useful websites

American Accounting Association	www.aaahq.org
American Institute of Certified Public Accountants	www.aicpa.org
CFA Institute	www.cfainstitute.org
Financial Accounting Standards Board	www.fasb.org
Financial Executives International	www.financialexecutives.org
New York Stock Exchange	www.nyse.com
Public Company Accounting Oversight Board	www.pcaobus.org
Securities and Exchange Commission	www.sec.gov

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

8.1* 'US accounting is the best in the world.' Discuss.

8.2* To what extent, if at all, is US GAAP influenced by accounting in other countries?

8.3 Which US accounting practices seem out of line with those of IFRS or of many other countries? What explanations are there for this?

8.4 Discuss the causes of differences in financial reporting and its regulation (giving relevant examples of the effects) between your own country and the United States.

8.5 'The most important influence on US accounting has been and remains the SEC.' Discuss.

8.6 As pointed out in this chapter, the United States and United Kingdom are reasonably similar with respect to the causes and nature of differences in financial reporting. Identify and discuss factors that may account for the existing differences in practices between US GAAP and UK national rules.

8.7 Would you describe the differences between IFRS and US GAAP as 'major'? Will it be easy for the standard-setters to remove these differences?

9 Key financial reporting topics

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OBJECTIVES

After reading this chapter, you should be able to:

- outline the major issues involved in revenue recognition;
- explain the importance of intangible assets and which ones are recognized;
- outline the variations in asset and liability measurement bases;
- critically summarize the treatment of financial instruments, including hedge accounting;
- explain the difference between provisions and reserves;
- distinguish between pension arrangements, pension provisions and pension funds, and give examples of how all these can differ from country to country;
- illustrate the causes of deferred tax and explain how there are various ways of accounting for it;
- outline the variations in liability measurement bases;
- discuss the treatment of some gains and losses as other comprehensive income.

9.1 Introduction

Chapters 5–8 have examined the regulatory context and many of the accounting requirements of IFRS and US GAAP. Some comparisons of these two major accounting systems have been made. This chapter takes these comparisons further for some topics which generate key accounting numbers that affect the making of financial decisions. We concentrate on topics that can have a large quantitative effect and which remain controversial. We consider particularly the practices of listed groups. Some other important issues, including US/IFRS comparisons, have already been discussed in Chapter 8, such as lease accounting and share-based payments. All of the topics affect consolidated financial statements, but we do not examine specific consolidation issues, such as goodwill or currency translation. These somewhat complex matters are left for Part V of this book (Chapters 16–18).

We first look at revenue (Section 9.2), which is likely to be the largest number (other than totals) in any company's financial statements. On this topic, a major new standard was issued in 2014. Much of the rest of the chapter relates in some way to assets and liabilities, although obviously these affect income and expenses. Accounting for assets and liabilities is a five-stage process:

1. Is the item an asset (or liability)?
2. Should it be recognized on the balance sheet?
3. How should it initially be measured?
4. How should it subsequently be measured?
5. How should it be removed (depreciation, impairment, derecognition)?

A definition of an asset can be found in the conceptual frameworks of the IASB or the FASB. These were examined in Chapters 6 and 8. However, not all assets are recognized in balance sheets. We consider the *recognition* of intangible assets first

(in Section 9.3), which involves one large difference between IFRS and US accounting. Then, we look at the *measurement* of assets (Section 9.4), noting that IFRS allows much more flexibility than US GAAP. Financial instruments, both assets and liabilities, are the topic of Section 9.5. Various other sorts of liabilities are then looked at in Sections 9.6 to 9.8: provisions, employee benefits and deferred tax. Section 9.9 takes an overview of the measurement of liabilities. Finally, in Section 9.10, we look at the presentation of comprehensive income, which includes the income and expense aspects of topics in the rest of the chapter.

9.2 Revenue recognition

9.2.1 Introduction

Until 2018, the IASB's old standards on revenue recognition, IAS 11 and IAS 18, can continue to be used. The latter deals with the main types of revenue, and IAS 11 deals with construction contracts. US GAAP had much more detailed and complex instructions. These standards are discussed in 9.2.2. All these standards are replaced for 2018 onwards by IFRS 15 and virtually identical requirements issued by the FASB, as explained in 9.2.3. These standards were allowed to be adopted early, except for any national restraints on that, such as EU endorsement.

9.2.2 IFRS and US GAAP before 2018

According to IAS 18 (paragraph 7):

> Revenue is the gross inflow of economic benefits during a period arising in the ordinary course of activities of an entity when those inflows result in increases in equity . . .

This definition fits with the distinction in the IASB *Framework* (paragraph 4.29 in the 2010 version) between 'revenue' (e.g. sales) and 'gains' (e.g. on the sale of fixed assets), as pictured in Figure 9.1. However, there were severe problems with the definition, as examined by Nobes (2012). First, the revenue is not the benefits, such as cash (which is a *debit*). Instead, the revenue is the increase in equity (which is a *credit*) that results from the inflow of the benefits. Secondly, the word 'ordinary' is not useful here; the sale of fixed assets is also 'ordinary'. From 1993, IAS 8 greatly restricted the content of 'extraordinary'; and, from 2005, IAS 1 abolished the concept. So, all inflows are ordinary. Thirdly, some sales of inventory are at less than cost, so they lead to decreases in equity. Does this mean that they not 'revenue'? If the IASB would reply that the

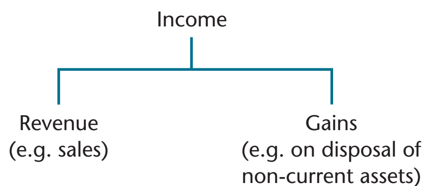

Figure 9.1 IASB's definitions related to income

gross effect must be considered, then the last eight words in the definition above are redundant because any sale (whether of current or fixed assets) has some inflow. Presumably the definition is supposed to say that revenue is the gross income from selling things to customers. This could still be ambiguous, because it rests on a definition of 'customers', but at least it would not be manifestly wrong.

Incidentally, it then becomes clear that 'revenue' is sometimes *associated* with 'income' and sometimes not. Indeed, 'revenue' is not a type of 'income', but its occurrence usually means that some income or loss needs to be recognized.

Under IAS 18, revenue from sales (and therefore income) should not be recognized until 'the entity has transferred to the buyer the significant risks and rewards of ownership [and control]'. For example, a binding sales contract is not yet 'revenue' until delivery has occurred.

Under US GAAP, the hurdles for the recognition of revenue had been set even higher, and toughly enforced by the SEC. Staff Accounting Bulletin 104 does not allow revenue recognition until all four of the following conditions are satisfied:

(i) persuasive evidence of an arrangement;
(ii) delivery;
(iii) price is fixed or determinable; and
(iv) collectibility is reasonably assured.

There was also a large amount of detail surrounding this, particularly in statements from the EITF. Furthermore, US GAAP had detailed instructions related to many different industries.

Traditionally, the domestic laws of most countries have been silent on this issue, so if a company changes its accounting to IFRS or to US GAAP, this may result in later revenue recognition.

Strangely, under contract accounting, the above logic and rules were abandoned. For example, IAS 18 (for services) and IAS 11 (for construction) required the stage-of-completion method for those uncompleted contracts which could be estimated reliably and look profitable. The same applied to construction contracts under US GAAP. Take the example of an apparently profitable five-year fixed-price contract to build electric trains. Suppose that there has been no delivery to the customer because all the trains are half complete. Should we take profit so far under IAS 11? Yes. Has there been any transfer of risks and control to the customer? No. Clearly, there are two quite different models of revenue recognition in these standards, and this was one reason for replacing them with IFRS 15, as explained below.

Let us take a simpler example. Imagine a magazine publisher who sells £100 non-refundable subscriptions on 1 January 200X, and promises to supply 12 magazines in the year. Taking all the other customers into account, the average cost of production and delivery for the total of the 12 magazines is expected to be £75. When should the publisher recognize profit? The traditional answer is that the £25 profit should be recognized gradually over the year. Therefore, to start with, the £100 is recorded as a liability. However, note that there cannot really be a liability of £100 because there is no probable outflow of £100. Another possible answer would be as follows (on 1 January):

(i) Is there an asset? Yes, £100 in the bank.
(ii) Is there a liability? Yes, the obligation to provide 12 magazines at an expected cost of £75.
(iii) Therefore, there is an immediate increase in equity of £25, which must be income.

Apart from the fact that this result fits the *Framework*, it also makes some sense: the difficult bit for the publisher is not producing magazines but finding customers prepared to pay £100. Once the latter is done, 'performance' has been effectively achieved. Nevertheless, the standard-setters have always been opposed to recording immediate gains on contracts, and this is still the case in the new standards discussed below.

9.2.3 IFRS 15 and the equivalent US GAAP

In 2004, the IASB and the FASB began grappling with this major issue of revenue recognition. This resulted in a jointly issued discussion paper in 2008 and a joint exposure draft in 2010. The final result was a joint standard in 2014 to be applied from 2018 at the latest: IFRS 15 and revisions to ASC606-10. This introduces a single model for revenue recognition. Among other things, this abandons the stage-of-completion method unless control passes to the customer as work progresses. Also, in the case of US GAAP, the industry variations are swept away.

Although the IFRS and US GAAP requirements are nearly identical, they have different definitions of 'revenue'. In IFRS 15, revenue is: 'income arising in the course of an entity's ordinary activities'. This preserves the problem relating to 'ordinary', as discussed above in 9.2.2. The US definition does not contain the word 'ordinary'; it refers to 'activities that constitute the entity's ongoing major or central operations' (ASC 606, Glossary).

Under the new standards, revenue is either recognized at a point in time (e.g. on delivery to the customer) or over a period. The latter is the case when any one of the following three conditions applies:

1 when the customer receives and consumes benefits immediately (e.g. when electricity is provided);
2 when the customer controls an asset as it is provided (e.g. building a bridge on the customer's land);
3 when the supplier creates an asset with no alternative use *and* the supplier has a right to payment for work done (e.g. supplying an audit or consultancy).

However, none of these conditions would normally cover building a boat for a customer in the boat-builder's shipyard under a contract with a substantial part of the payment due on delivery. Therefore, for such a contract, the percentage-of-completion basis is no longer used.

9.3 Recognition of intangible assets

The recognition criteria for assets under the original IFRS *Framework* (that was in force when all the major standards on assets were written, and is still in force in 2015) are that the inflows expected from an asset should be probable (i.e. more likely than not) and that the cost or value of the asset should be measurable reliably (e.g. *Framework*, paragraph 4.37; and IAS 38, paragraph 21). To apply this, it is first necessary to distinguish between three ways of obtaining intangible assets: internal generation, separate purchase and purchase as part of a business combination. There is little controversy

over separate purchase: if an asset (e.g. a patent or a brand name) has been purchased, it should generally be recognized. There is greater difficulty with the other ways of obtaining such an asset.

Internally-generated assets might fail to satisfy the recognition criteria of probable inflows and reliable measurement. On such grounds, IFRS and US GAAP ban the capitalization of internally-generated goodwill, research costs and brands. US GAAP goes further and requires expensing of development costs, except in the special case of computer software development. However, IFRS (in IAS 38) requires capitalization of development costs when they meet certain criteria, which are an elaboration of the above recognition criteria. It thus becomes necessary to distinguish between 'research' and 'development', and then to use the criteria.

IAS 38's definitions are:

> Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge or understanding.
>
> Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved material devices, products, processes, systems or services. (paragraph 8)

The criteria for capitalization (paragraph 57) include the availability of resources to complete the development and the ability to show how future benefits will arise and to measure the expenditure. Although judgement is involved in all this, Volkswagen's adjustment from German to IFRS accounting (examined in Chapter 2, but repeated here for convenience as Table 9.1) shows the large potential size of the resulting asset: an increase of 41 per cent in net assets.

Let us take the examples of two types of development project. The first is a new computer-based accounting system, built internally by a bank. From a very early stage in such a project, all the criteria will be satisfied, so the costs are recognized as

Table 9.1 Volkswagen 2001 (opening reconciliation)

	€m
Equity (German law) 1.1.2000	9,811
Capitalization of development costs	3,982
Amended useful lives and depreciation methods of tangible and intangible assets	3,483
Capitalization of overheads in inventories	653
Differing treatment of leasing contracts as lessor	1,962
Differing valuation of financial instruments	897
Effect of deferred taxes	(1,345)
Elimination of special items	262
Amended valuation of pension and similar obligations	(633)
Amended accounting treatment of provisions	2,022
Classification of minority interests not as part of equity	(197)
Other changes	21
Equity (IFRS) 1.1.2000	20,918

Source: Adapted from *Volkswagen Annual Report 2001*, Volkswagen AG, Wolfsburg, Germany.

assets, not expenses. The second project is the search for a new drug to cure heart disease. GlaxoSmithKline explains as follows in its 2014 Annual Report:

> Development expenditure is capitalised when the criteria for recognising an asset are met, usually when a regulatory filing has been made in a major market and approval is considered highly probable.

This will be near the end of the project. Incidentally, capitalization begins from the day the criteria are met, not from the start of a project. Any previous expenditure cannot be added later to the asset. Capitalization stops when the asset is ready for use.

When intangible assets arise in the third way, acquisition as part of a business combination, further complications arise. Standards issued in the early 2000s (SFAS 141 in the US, and IFRS 3) were designed to persuade purchasers to recognize as many identifiable intangibles as possible, thereby reducing goodwill. For example, IAS 38 (paragraphs 25 and 33) presumes that the act of purchase satisfies the recognition criteria.

A large amount of research has been published on the importance of intangibles and whether it is useful to include them in balance sheets. This is summarized by Basu and Waymire (2008), Skinner (2008) and Wyatt (2008).

9.4 Measurement of assets

If assets are recognized, they then have to be measured. Until recently, the universal way of measuring assets, at least initially, was at their cost. This continues to be the case for most assets, such as intangible assets and PPE (which could also be called tangible fixed assets), where the 'cost' basis includes reductions for depreciation and impairment. However, if an asset is to be measured subsequently at fair value (or fair value less costs to sell; see below), then perhaps it should initially be measured in the same way. IFRS now takes this view for some assets that are required later to be held at fair value, i.e. certain financial assets (IAS 39) and biological assets (IAS 41). These facts are recorded in the column headed 'Initial' in Table 9.2.

IFRS also *allows* subsequent fair valuation for several other types of assets (the column headed 'Subsequent' in Table 9.2), largely because the standard-setters are not yet able to decide between verifiable costs and relevant fair values. By contrast, the

Table 9.2 Initial and subsequent measurement bases under IFRS

	Initial	Subsequent
Cost basis only	PPE, intangibles, investment properties, non-trading investments, inventories	Inventories, intangibles with no active market, held-to-maturity investments
Cost or fair value	Some non-trading investments	PPE, intangibles with active market, investment properties, some non-trading investments
Fair value only	Trading investments, derivatives, biological assets	Trading and available-for-sale investments, derivatives, biological assets

US rules come down more clearly in favour of cost and require it, except for use of fair values for some types of investments (see Section 9.5). For subsequent measurement, the 'cost' basis means as reduced by depreciation or impairment when appropriate.

As explained in Chapter 6, 'fair value' is used in IFRS and US GAAP to mean a current market exchange price between willing buyers and sellers. The FASB decided (in SFAS 157 of 2006) that 'fair value' should particularly be an exit value, i.e. what an entity could sell the asset for. This was soon followed by IFRS 13. For example, for financial assets the bid price is used (i.e. the price that an entity would get when selling the asset, which would be lower than the ask/offer price). However, as this measure is still not intended to be net of the costs of sale, it is not a true exit value.

Section 5.5 in Chapter 5 briefly records the various measurement bases used for the subsequent measurement of different assets under IFRS. In addition to the use of cost and fair value for various assets, impaired assets are valued at the higher of value in use (discounted cash flows) and fair value less costs to sell. This large range of measurement bases is recorded as Figure 9.2. That figure does not separately show depreciated historical cost, which is neither cost nor a market value. Assets held at depreciated cost move gradually from cost (i.e. initial fair value plus costs of buying) to residual value (i.e. net realizable value) over life.

Although the 'Revalued' cost heading in Figure 9.2 refers to amounts measured at fair value, no gains are taken as profit on revaluation and the value is used as a new cost for depreciation and disposal calculations. This is quite different from the 'Fair value' heading, under which there is no depreciation. The meaning of 'entity-specific value' (on the right of the figure) is that the management of the entity estimates the cash flows and the discount rate, so the value is not verifiable from outside of the entity.

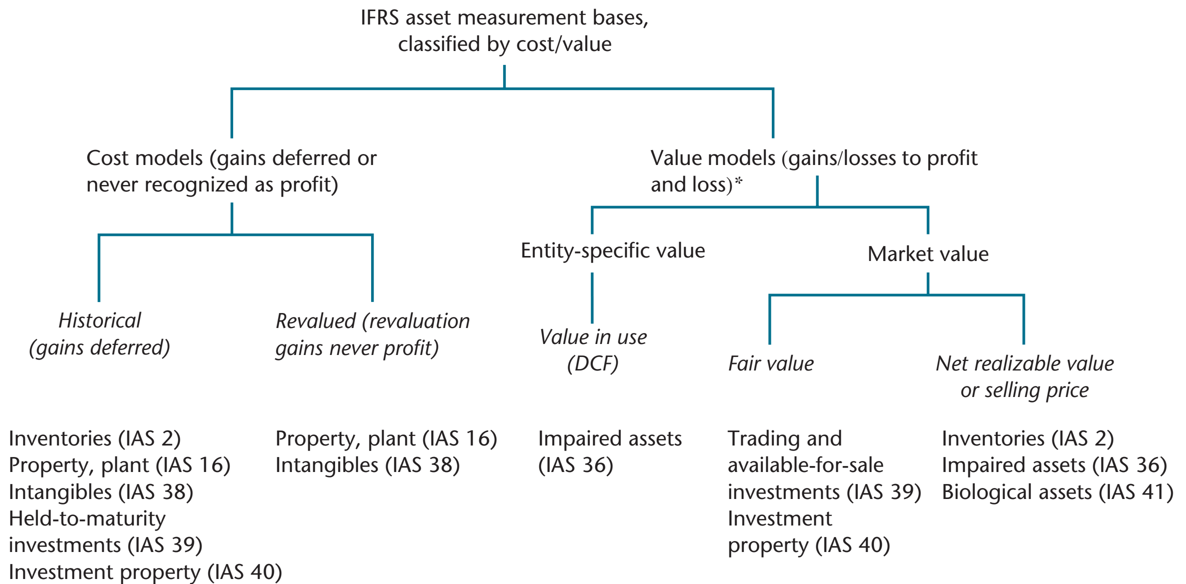

Figure 9.2 IFRS asset measurement bases, classified by cost/value

Note: * Except that gains/losses on available-for-sale investments are deferred.
Source: Nobes, C.W. (2001) Asset Measurement Bases in UK and IASC Standards, ACCA, London.

Figure 9.2 does not show compound measurement bases such as 'the lower of cost and net realizable value'. Therefore, inventories are shown twice in Figure 9.2. Another compound basis that appeared often in the literature of the 1970s and 1980s is 'deprival value' (e.g. Gee and Peasnell, 1976). This is the lower of current replacement cost and recoverable amount (RA), where RA is the higher of DCF and selling price. An echo of this can be seen in IAS 36 on impairment; impaired assets are measured at the lower of pre-damage carrying amount (usually depreciated cost) and recoverable amount.

As for the recognition of gains, imagine a piece of land that rises in market value. There are three possibilities for the recognition of gains in profit or loss:

- IAS 16/40 Cost basis: gain deferred until sale;
- IAS 16 Fair value basis: gain recorded as OCI but never recognized as profit or loss (see Section 6.5.1 in Chapter 6);
- IAS 40 Fair value basis: gain recognized immediately as profit or loss.

This gets even more complicated when depreciation is taken into account, especially when depreciated revalued assets are then impaired. Clearly, some order needs to be brought to this. The IASB and the FASB have a very slow project in this area, which led to the publication of a discussion paper about initial recognition in 2005. However, it is unlikely that the conceptual framework project (e.g. the IASB's exposure draft of 2015) will lead to much change.

9.5 Financial instruments

9.5.1 Financial assets

As noted in Chapter 8, the main departure from the cost basis under US GAAP relates to the measurement of financial assets that are held for trading or are available-for-sale. For them, the FASB considered that the financial markets were liquid enough to enable a reliable measurement of market value. This was put into effect in SFAS 115 of 1993, and extended to derivative assets and liabilities by SFAS 133 of 1998. A derivative is a financial contract that has a net worth of little or nothing on the day that it is signed but gets a value when some underlying price (e.g. an interest rate or an exchange rate) changes. An example of a derivative held by a European company would be a forward dollar contract. If the dollar rises in value after the contract is taken out (usually at spot rate), the derivative becomes an asset. Before SFAS 133, such assets and liabilities (and the connected gains and losses as prices change) were not recognized.

For trading and derivative items, the gains and losses go to profit or loss (marking to market). However, in order to protect the net income figure from volatility, the gains and losses on available-for-sale assets (those non-derivatives not intended for trading) go to other comprehensive income. The IASC followed all this in IAS 39, extending it even to equity instruments that have no active market. The IASB went further and amended IAS 39 in 2004 in order to allow an entity to choose to measure many other financial assets at fair value. These are called 'designated at fair value through profit or loss'. This issue caused a disagreement with the EU which was eventually resolved by the IASB restricting this category (see Chapter 10). In 2007, the FASB

Table 9.3 Financial assets under IFRS and US GAAP

	Measurement	Fair value movements to:
Held-to-maturity; loans	Amortized cost	None
Available-for-sale	Fair value	Other comprehensive income
Trading; derivatives; designated assets	Fair value	Profit or loss

also introduced this option in SFAS 159. Table 9.3 summarizes the position, except that, in US GAAP, non-marketable securities are not held at fair value. Although the wording of IFRS 9 (see below) is different from that of IAS 39, the same choices exist.

Those assets not fair valued should be measured at amortized cost, which is a treatment exactly like that for a tangible fixed asset, i.e. the asset is initially held at cost, then amortized down to expected residual value over its expected life. For example, imagine that a company buys for $1,100 a five-year government bond with a maturity (face) value of $1,000, because the interest rate on the bond is attractively high. The asset is initially recorded at $1,100 and then amortized over five years to $1,000. The amortization expense partially sets off the interest income. Because the face value is reliable, we would also amortize *up* to it rather than merely *down* to it, unlike for other fixed assets.

For a bond that is held to maturity, it can be argued that fluctuations in market value are not relevant because the company will not be affected by them. At the other extreme, the same bond could be intended for short-term sale, and so the fluctuations in market value are relevant. The problem is that the intentions of directors are difficult to audit, may not be clear even to the directors and can be changed. Consequently, an alternative argument is that identical bonds should be measured identically, irrespective of the alleged intentions of the directors.

The managers of companies do not generally like volatility of income, so they like to treat as 'trading' as few assets as possible. As some financial assets clearly cannot be held to maturity because they have no maturity date (e.g. shares), it is common for companies (except financial institutions) to treat most financial assets as available for sale. In contrast, the standard-setters originally believed that all financial assets should be treated as 'trading' (JWG, 2000). This is why the IASB added the option to IAS 39 for other financial assets to be treated in the same way as a trading asset.

Once a financial asset is put into a category on initial recognition, the standards contain rules that prohibit or restrict re-classification. However, treating financial assets as 'trading' becomes especially unpopular when market prices fall dramatically as they did in 2008 and 2009. Accounting was blamed by some for making the financial crisis worse by displaying all the losses caused by 'marking to market'. Pressure, especially from the EU, was put on the IASB to allow re-classification out of 'trading', and it did so by allowing this under 'rare circumstances' (IAS 39, para. 50B). CESR (2009) found that about half of the 100 EU financial companies that it surveyed had taken advantage of the amendment. Chapter 10 includes a discussion of the politics of this change. A number of academic studies (e.g. Barth and Landsman, 2010) examine whether accounting did cause or exacerbate the crisis. They conclude that it did not.

In July 2009, under pressure from governments and regulators to simplify IAS 39, the IASB issued an exposure draft, which proposed to remove a number of the complications in the standard. The resulting IFRS 9 was issued, for compulsory use from 2013. However, this version of IFRS 9 was never endorsed for EU purposes, and its implementation date was postponed. The full version of IFRS 9 was not published until 2014, for compulsory use from 2018. The content of IFRS 9 is summarized in the Appendix to Chapter 6.

Under the national rules of countries where rules have not yet been extensively converged with IFRS (e.g. in France or Germany), financial assets are still measured at cost or the lower of cost and market. This does not apply to banks, which preceded other companies in their use of market values for investments.

9.5.2 Financial liabilities

The first issue here is to determine whether an item is a liability or a part of equity. IAS 32 broke new ground in the 1990s by requiring any item that meets the definition of a liability to be recognized as one even if it was called something else. This applies to certain preference shares. As a reminder, the IASB definition is:

> A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
>
> *Framework* (paragraph 4.4)

From 2003 (with SFAS 150), this has also applied in US GAAP.

Similarly, IAS 32 departed from existing conventions by requiring compound instruments (e.g. convertible debentures) to be split into elements of debt and equity based on economic substance. Most national rules, including US GAAP, base accounting on the legal form of the instrument.

Once a liability is recognized, the normal procedure is to measure it at amortized proceeds: the mirror image of amortized cost. However, US GAAP and IFRS require *trading* liabilities to be treated like trading assets, i.e. 'marked to market' (fair valued, with gains and losses to profit and loss). The same applies to derivative liabilities. In 2004 and in 2005, IAS 39 was amended to allow certain other liabilities to be marked to market. IFRS 9 has a similar option. SFAS 159 did the same for the US. This is designed to allow financial institutions to hold parts of their balance sheets, on both sides, at fair value.

9.5.3 Hedge accounting

The degree to which hedge accounting is allowed is a major topic of controversy, leading to a difference between IFRS and EU-endorsed IFRS (see Chapter 5). In IAS 39, there were 32 paragraphs (out of 110) on hedge accounting, followed by 13 pages of 'application guidance', 29 pages of 'basis for conclusions' and 108 pages of 'implementation guidance' on the subject. This subsection can, therefore, only outline the issue.

In order to understand this topic, it is necessary to distinguish between four issues:

1 hedging;
2 a hedged item;

3 a hedging instrument;
4 hedge accounting.

Hedging is protecting an entity from the effects of movements in prices, such as those of commodities or currencies. Items that can be hedged are an asset, a liability, a net investment in a foreign operation, a commitment or a forecasted transaction that exposes an entity to changes in fair value or cash flows that can affect profit and loss. For example, suppose that British Airways (BA) made a commitment on 1 July 2016 to buy $500 million of aeroplanes from Boeing on 31 December 2017. If BA's functional currency (see Chapter 17) is pounds sterling, this commitment in dollars exposes the company to the risk that the dollar will rise, worsening its expected cash outflows in pounds. Such an item can be hedged.

A hedging instrument is a financial asset or liability whose changes in fair value or cash flows are expected to offset the changes of the hedged item. In the BA example, the company might buy from a financial institution, on 1 July 2016, $500 million to be delivered to it on 31 December 2017 in exchange for £330 million at that date. British Airways would then have protected itself against a rise in the dollar by buying the forward dollar contract (a derivative financial instrument).

As explained earlier, the derivative contract would probably have been fixed at approximately the exchange rate ruling on the day it was signed. So, at inception, there would be little to account for. Subsequently, under the normal accounting requirements of IAS 39, IFRS 9 or US GAAP, the derivative is marked to market. For example, if the dollar falls against the pound, the derivative contract is a liability, and a loss is immediately recorded. Paradoxically, BA's attempt to protect itself from changes in the dollar has resulted in a loss caused by a fall in the dollar. The reason is that the commitment to pay dollars to Boeing is not recorded under present accounting rules. So the fall in the pound value of the commitment is not accounted for.

In order to protect 'profit or loss' from gains and losses during the life of the hedging instrument, it is necessary to use hedge accounting. This is a departure from the normal accounting rules and, in this case, allows an entity to record the gains and losses on the derivative as 'other comprehensive income'.

Suppose that the dollar continues to fall and that BA honours its commitment to buy the planes. BA can record the planes at a cost of £330 million, which includes all the accumulated losses on the derivative. So, no currency losses need ever be recorded as profit or loss. Of course, if BA had not taken out the forward contract, it would record the planes at a lower cost and would then have lower depreciation expenses and higher profits over the life of the planes.

There are three main possible attitudes towards hedge accounting:

1 leave it to a company's discretion (this is approximately the position in EU national laws, for example);
2 allow it under certain conditions (as in IAS 39, IFRS 9 or US GAAP, see below);
3 ban it altogether (as once proposed by the IASC, FASB and others: see JWG, 2000).

Using the above example, the argument for banning hedge accounting is that BA has taken a bet on the dollar. So, if the dollar falls, it has lost the bet and should

recognize the loss immediately, not disguise it as depreciation expenses of some later years. Similarly, if the dollar rises, there is a gain.

Company management sees hedging in a different way (i.e. as a sort of insurance contract) and has successfully lobbied the standard-setters to include permission for hedge accounting. IFRS and US GAAP allow hedge accounting when there is evidence that the hedging instrument was not a bet (e.g. on the dollar, in our BA example). In particular, hedge accounting is allowed when a hedging instrument is expected to be fully effective against the risk (as it would be in the BA example) and when the entity documents the nature and purpose of any purchase of the hedging instrument. IFRS 9 has somewhat similar conditions.

The restrictions imposed on hedge accounting by IAS 39 were too restrictive for certain companies (especially French banks) who lobbied the EU successfully to have some of them removed from the version of IAS 39 endorsed by the EU in 2004.

9.6 Provisions

9.6.1 Definition

Provisions are defined by IAS 37 as liabilities of uncertain timing or amount. A good example is provisions for pensions, although they are covered by a more detailed standard (see Section 9.7). Suppose that a company promises to pay a pension to an employee when she retires. The pension will be paid every year from retirement to death, and will be equal to half the final year's salary. The pension entitlement builds up to this as the employee continues to work for the company. Such an entitlement is called a 'defined benefit pension'.

From the company's point of view, the pension is part of employee compensation; it is a current staff expense with a postponed payment date. Each year, the company should charge a staff pension expense and increase the liability to pay the pension later. It is clear that the obligation to the employee meets the above definition of liability (see 9.5.2):

- past event: the employment contract followed by the employee working;
- present obligation: caused by the employee having worked;
- future outflow: the expected payment of the pension.

However, the exact amount depends on many things, such as the final salary and how long the employee will live after retirement. Consequently, the company can only *estimate* the amount, and so the liability is called a *provision*. More details on pension provisions are given in Section 9.7.

Other examples of provisions are estimates of liabilities to pay tax bills or, in the case of a mining company, to pay for cleaning up the environment after extracting minerals from the earth. Also, many companies have obligations for future repair costs on products that they have sold, as a result of warranties given at the time of sale, so they must recognize provisions.

The particularly controversial issue in the area of provisions is the degree to which anticipated expenses and losses should be provided for. The Fourth Directive (Art. 12,

para. 12 as amended in 2013), on which laws in EU countries are based, states that provisions are:

1 liabilities likely to be incurred or certain to be incurred but of uncertain timing or amount; and
2 at the option of each country's lawmaker, the heading can also cover charges to be incurred in the future but with origins before the balance sheet date.

This allows the creation of provisions for trading losses, currency translation losses or repair expenses of an ensuing year, which are connected to actions of current or earlier years. Section 2.9.1 gives examples of these under German accounting. Under IFRS requirements, such items generally do not meet the definition of a liability and should not be provided for. Fortunately, the EU's item 2 in the above list is only an option, so there need not be an incompatibility with IFRS.

As an example, suppose that a company has a 31 December 20X1 year end. It has had a very bad year, and its directors decide at a board meeting on 15 December 20X1 to close down half the factories and to lay off half the staff at the end of January 20X2. Detailed plans are made and minuted at the board meeting. However, in order to avoid an unhappy Christmas for the staff, the plans are kept secret until 7 January 20X2. When the financial statements for 20X1 are prepared in February 20X2, should the balance sheet record a provision for the large restructuring and redundancy costs?

The traditional (and prudent) answer to this question would be 'yes', and there would be no problem in fitting such a provision into the EU Fourth Directive's optional definition (as above). However, is there a liability at the balance sheet date? There is expected to be a future outflow of resources, but the same could be said for the wages bill of 20X2, which we would not expect to charge in 20X1. Is there an obligation to a third party on 31 December 20X1? The answer, depending on the exact circumstances, seems to be 'no'. Therefore, no provision should be recognized under IFRS requirements, although the notes to the financial statements must explain the situation.

Does an IFRS balance sheet give a fair presentation as it does not recognize a provision for the expenses of restructuring that had been decided upon by 31 December 20X1 and that were highly likely to be paid early in 20X2? In order to answer this question, it is necessary to remember that the financial statements are prepared using a series of conventions that users are expected to be familiar with. The definition of 'liability' under the IFRS regime has been the same for over two decades and is published in the *Framework* and various standards. Would it be fair to show an item under the heading 'liabilities' that clearly did not meet the definition? Probably not. Furthermore, unless everyone sticks to this clear definition, it is very difficult to stop companies from warping profits by choosing to make provisions in good years but not in bad years.

In order to inform the users, IFRS requires disclosures in the notes about any restructuring proposals when they have been announced or begun by the date that the financial statements have been authorized for issue.

The requirements for setting up provisions in the US have become even stricter in 2002 when SFAS 146 required that an announcement of a detailed formal plan is not enough: there must be an event that removes discretion for the spending from the management (now ASC 420-10-25). This means that a provision might be recognized even later under US GAAP.

When a provision is to be recognized, it becomes necessary to measure it. By definition, there are estimates to make. The accountant must make the best possible estimates and be prepared to revise them at each balance sheet date in the light of better information. Provisions, such as those for decommissioning a nuclear power station, may extend decades into the future. This suggests that measurement requires the use of discounting to take account of the time value of money. Discounting is now required under IFRS rules but has not been normal in the domestic rules of most continental European countries and is not required in the US for provisions in general.

9.6.2 Provisions and reserves

A major cause of confusion surrounding the issues in this chapter is an international difference in the use of the words 'provision' and 'reserve'. One source of the confusion is the use of the word 'provision' to mean a reduction in the value of an asset (e.g. a so-called 'bad debt provision'). It would be more helpful to call value adjustments against receivables 'allowances' or 'impairments' rather than provisions or reserves. It is also important to remember that provisions are obligations to pay money (liabilities), not funds of money (assets).

By contrast, a reserve is an element of shareholders' equity. There is a vital distinction between a provision and a reserve. Setting up a provision for €1 million would involve:

Debit: Expense	€1 m
Credit: Liability	€1 m

Setting up a legal reserve (see Chapters 11 and 15), for example, would involve:

Debit: Equity (profit and loss reserve)	€1 m
Credit: Equity (legal reserve)	€1 m

Setting up a provision in the manner described above decreases profit and net assets, whereas setting up a legal reserve affects neither.

Further terminological confusion is caused because of a difference between UK and US usages. In the United Kingdom (and in IFRS), the distinction between 'reserve' and 'provision' is as used throughout this chapter: a reserve is an element of equity, and a provision is a type of liability. However, as mentioned in Chapter 2, in the United States the word 'reserve' is used to mean both 'impairment' and 'provision'. For example, Americans refer to a 'loan loss reserve' (rather than an impairment of receivables) and to a 'pension reserve' (rather than a pension provision). This is not confusing to Americans because they seldom use the word 'provision' at all, and they generally do not use the word 'reserve' to mean a part of equity. Indeed:

- there are no legal reserves in the United States;
- revaluation reserves relating to investments are shown as 'cumulative other comprehensive income';
- reserves caused by currency translation (see Chapter 17) are called 'cumulative translation adjustments';
- profit or loss account reserves are called 'retained earnings'.

The confusion arises when translators or analysts fail to spot this UK/US difference. Table 2.10 in Chapter 2 summarizes the words used in several languages.

Another expression that is often found, particularly under the domestic rules of prudent countries (e.g. Germany) and particularly relating to banks, is 'secret reserves' or 'hidden reserves'. These would arise because a company:

- failed to recognize an asset in its balance sheet; or
- deliberately measured an asset at an unreasonably low value;
- set up unnecessarily high provisions.

These actions might have been taken in the name of prudence or, in some countries, in order to get tax deductions. In all three cases, net assets will consequently be understated and therefore, of course, equity will be understated. The amount of understatement could be called a secret reserve.

Most systems of accounting contain some degree of secret reserves. For example, the IFRS, German and US regimes do not recognize the internally generated asset 'research'; and it is normal to measure many assets at depreciated cost, which is often below fair value. A good time to spot secret reserves is when a company changes from one system of accounting to another. For example, in 1996 Germany's largest bank, the Deutsche Bank, published for the first time financial statements under IFRS as well as under German accounting. The bank's figures for equity are set out in Table 9.4 and illustrate a big increase in disclosed reserves under IFRS. The analysis of return on net assets or the comparison of debt to equity would have been greatly affected by this. The Volkswagen reconciliation from German GAAP to IFRS (see Table 9.1) also shows the removal of over €2bn of 'unnecessary' provisions.

9.6.3 Contingent liabilities

Another topic to consider here is 'contingent liabilities'. Suppose that Company X borrows €1 million from the bank but can only do so by persuading Company Y to promise to pay the loan back to the bank in the unlikely event that Company X cannot do so. Company Y has thereby guaranteed the loan. Is this guarantee a liability for Company Y? There is a legal obligation, but it is unlikely to be called upon. These unlikely outflows caused by obligations or by possible obligations are called *contingent liabilities* and should be disclosed in the notes to the financial statements, as required by IAS 37 and under many sets of national rules.

This leads to a curious result. Suppose that an entity has two obligations as a result of past events:

Table 9.4 Deutsche Bank equity (DM million)

Year	German GAAP	IFRS	% increase
1994	21,198	25,875	22.1
1995	22,213	28,043	26.2

- Problem A is a 60 per cent likelihood of having to pay €10 million soon (and a 40 per cent likelihood of paying nothing).
- Problem B is a 40 per cent likelihood of having to pay €10 million soon (and a 60 per cent likelihood of paying nothing).

How should these obligations be measured?

Under IAS 37, the answer is that A is valued at about €6 million and B at zero. The measurement of A should be at 'the amount an entity would rationally pay to settle the obligation at the balance sheet date or transfer it to a third party' (IAS 37, paragraph 37). If A could find an insurance company to take the problem away, the price in an efficient market would be about €6 million. By contrast, problem B does not have a probable outflow so should not be recognized at all, merely noted as a contingent liability.

An IASB exposure draft of 2005 proposed to take probability out of the recognition criteria and have it in measurement only. Consequently, problem A would continue to be measured at €6 million but problem B would be measured at €4 million. One implication of this would be the removal of the concept of 'contingent liability'. This project never led to the amendment of IAS 37. However, the same idea (i.e. moving the issue of probability from recognition to measurement) can be found in the 2015 exposure draft of the conceptual framework.

9.7 Employee benefits

9.7.1 Introduction

Pension obligations have already been referred to (in Section 9.6.1) as an example of provisions. Similar obligations also arise where an employer promises to pay an employee's medical bills after retirement. This is common in the United States, as noted in Chapter 8.

This section examines the international variations, first in the institutional arrangements for pensions between companies and their employees, then the recognition of obligations, and then the funding of obligations. Another employee benefit, share-based payments, was discussed in the context of the USA in Chapter 8.

9.7.2 Institutional arrangements

Several types of arrangement exist for ensuring that employees have some income after retirement. These include:

- state plans;
- industry plans;
- severance indemnities;
- defined contribution plans;
- defined benefit plans.

The term 'scheme' is sometimes used instead of 'plan' in British English.

Many countries have state pension plans, whereby companies (and sometimes employees also) are required to pay sums to the state, which then guarantees to pay a pension after retirement or when a certain age is reached. Once the company has paid its contributions, it has no further obligation. The payments amount to a form of taxation. The monies are generally absorbed into the government's budget, and the size of the eventual pension is determined year by year.

A defined contribution plan is one where an employer (and perhaps the employee) pays specified amounts of money into the plan, which is run by a pension trust or life assurance company. The resulting eventual pension will then depend on the success of the plan's investments. The employer has no obligation once the period's contributions have been made. Industry plans, which operate for example in some companies in the Netherlands and Sweden, work rather like a defined contribution plan but for all the companies in a particular industry. Again, once a company has paid its annual contribution, it has no liability.

By contrast, in a defined benefit plan, the employee is promised a pension which is not fixed in terms of the contributions. For example, the pension entitlement might build up over 20 years of service to equal one half of the employee's final year salary. The obligation of the employer is then dependent upon how long the employee will live after retirement and on what the final salary will be. Such plans are fairly common in Germany, the UK and the US.

Another example of defined benefit is a severance indemnity such as operates in Italy and Japan. For example, in Italy, the law imposes an obligation on employers to pay amounts to employees when they resign, retire or leave for any other reason. Approximately speaking, for each year of service completed an employee builds up the right to be paid one month of severance indemnity.

9.7.3 Accounting for defined-benefit obligations

Introduction

If an employer company has an obligation (e.g. for severance indemnities or for final salary plan pensions), the question is how to account for it.

In Italy and Japan, the calculation of the severance obligation is precise. Under domestic Italian rules, for example, the exact amounts are recognized as provisions in balance sheets, with changes in the year charged to the income statement. The amounts are not discounted for the time value of money. The charges are tax deductible.

In the US and under IAS 19, companies are required to estimate the obligation at the balance sheet date, using a discount rate based on current market interest rates. These calculations are not relevant for tax in several countries (e.g. in the US or the UK), because they involve so much estimation. That is, the resulting pension expense is not tax deductible. However, in Germany, because of the close tax and accounting link until 2010 (the *Massgeblichkeitsprinzip*, see Chapter 2), it was normal for accountants to follow the requirements of the tax system, which specified a discount rate and that no expected future pay rises should be accounted for. These and other assumptions generally led to under-provision, which had to be corrected by German companies adjusting to US GAAP or to IFRS (see, for example, the extra provision made by Volkswagen in Table 9.1).

Under the EU Fourth Directive (Art. 16 (1) (d) in the 2013 version), it seems to be possible merely to note pension obligations rather than to provide for them in the balance sheet. Several French companies do this under domestic rules, which means that they are not accounting for some of their liabilities. For example, L'Oréal's parent financial statements of 2014 report:

> No provision is recognised in the balance sheet for net unfunded obligations, which are shown in off-balance sheet commitments.

Actuarial gains and losses

A defined benefit obligation changes from year to year for many reasons, which can be divided into two types: surprises and non-surprises. The obligation increases for two unsurprising reasons: the employees keep working and therefore build up their rights to be paid pensions (this is called 'current service cost'), and the obligation gets one year nearer to being paid so there is one year less discounting (this is an interest expense or the unwinding of the discount rate). These expenses are charged to profit or loss.

Then there may be 'surprising' changes. These are called 'actuarial gains and losses'. For example, the following would cause actuarial losses: the company grants larger pay rises than expected (thereby increasing the size of the pension), the pensioners live longer than expected, or the discount rate falls. These losses may be large. If they were recognized immediately they would cause big, surprising debits in profit or loss. Company management does not like this, because management tries to make earnings rise smoothly in the medium term. Therefore, there has been pressure to find ways of protecting profit or loss from the truth. The FASB invented two ways in SFAS 87:

(i) if the actuarial gain or loss is small, ignore it (the limit for 'small' is set at 10 per cent of the larger of the obligation or the fund; this band is called 'the corridor'),

(ii) if the gain or loss is not small, smooth it over the average remaining service lives of the employees.

This meant that the balance sheet ignored the unrecognized gains and losses. These devices are splendid examples of 'rules' as opposed to 'principles' in an accounting standard. The IASC/B originally copied them into IAS 19 in order to satisfy management's complaints about volatility. However, IAS 19 also allowed any faster recognition. US GAAP was amended in 2006 by SFAS 158 (now ASC 715-30-35). It retains the above profit or loss treatment but requires full recognition in the balance sheet. The difference (the amount not yet recognized in profit or loss) is charged to other comprehensive income, and then gradually removed from there to income. IAS 19 retained the old US treatment as an option until 2013.

The UK's Accounting Standards Board invented another way of protecting profit and loss in FRS 17 of 2000: charge actuarial gains and losses in full in the statement of total recognized gains and losses (i.e. OCI). An option to do this was added into IAS 19 in 2004. In Chapter 7, there was an investigation of the choices made by large listed companies using IFRS. Table 7.4 showed that the OCI treatment was predominant in Australia and the UK but not in continental Europe. In 2011, IAS 19 was amended (with compulsory effect from 2013) to require actuarial gains and losses, and other re-measurements such as the return on plan assets, to be charged to OCI.

9.7.4 Funding of employee benefit obligations

It is important to note that provision (even full provision) does not mean that money or investments have been set aside to cover future payments to the employee. It might be a good idea to do this, but it requires the company to take deliberate action that is quite separate from accounting for the obligation. If money is sent irrevocably from the company into the hands of financial managers who will invest it so as to pay pensioners, this activity is called *funding*. The fund is not shown as an asset of the employer because it is no longer controlled. However, the value of the accumulated fund is set off against the accumulated obligation, because the fund can only be used to pay the pensioners, so this reduces the probable size of the company's liability. The balance sheet then shows the balance of the unfunded obligation as a provision.

It is vital not to confuse a provision with a fund. A provision is an obligation to pay money. A fund is a set of financial assets (money or investments). Internationally, the scope for confusion is considerable; for example, the Italian for 'provision' is *fondo*.

In the US and the UK, it is common for companies to engage in funding designed – in the long run – to cover their obligations. Indeed, some countries have laws requiring full funding over the long run. Of course, an obligation is an estimate and a fund goes up and down with the markets. So, exactly full funding is unusual. Incidentally, in the US and the UK, contributions to funds are tax deductible, because (unlike pension expenses) it is easy for the tax system to check them.

Table 9.5 shows an abbreviated version of the 2006 balance sheet of the US automobile giant, General Motors, which was heading for financial disaster for many years before the problem became very obvious in late 2008. In the liabilities section, there was a pension liability of $11.9 billion and a post-retirement health benefit liability of $50.1 billion. This dwarfed the stockholders' equity which was negative in 2006 and only $14.7 billion in 2005. The pension liability is the difference between a large obligation and a large fund. In contrast, there is little funding for the health obligations, so most of the obligation is shown as a liability. It should have been clear that General Motors would be unable to pay these enormous unfunded obligations, and eventually the company's share price fell close to zero.

If there is a fund as part of a pension plan, its assets are probably spread amongst various investments, such as government bonds, shares and investment properties. These are measured at fair value. Consequently, when markets fall, pension funds fall, and this is another actuarial loss. The exceptional market falls of 2008 created huge actuarial losses in countries with funded plans, such as the US and the UK. However, these were partly offset by actuarial gains caused by the rise in interest rates on corporate bonds during the credit crunch. This experience put the spotlight on to the question whether risk-free rates would be more appropriate (e.g. ASB, 2007).

In those continental European countries where company obligations are common (e.g. Germany and Italy), it is not usual to engage in extensive funding, although funding has increased in Germany (Lobe and Stadler, 2008). In the absence of funding, a company keeps for general purposes the money that might otherwise have been set aside. As pension provision expenses are tax deductible in these two countries, funding payments are not. Companies must ensure that they always have enough cash to pay the employee benefits falling due. The result of these practices is that large employee obligations can be seen on German and Italian balance sheets.

Table 9.5 Abbreviated balance sheet of General Motors as at 31 December 2006 (US$bn)

Cash and securities		24.7
Accounts receivable		8.2
Inventories		13.9
Deferred tax		44.9
Equipment leased out		17.9
Equity in associates		9.5
Tangible assets		41.9
Intangible assets		1.1
Other		24.1
Total assets		186.2
Accounts payable		28.1
Accrued expenses and other short debt		40.9
Debt		42.5
Post-retirement benefits (not pensions)		50.1
Pensions		11.9
Other		16.9
Total liabilities		190.4
Minority interests, etc.		1.2
Common stock	1.0	
Capital surplus	15.3	
Retained earnings	0.4	
Accumulated other comprehensive loss	(22.1)	
Total stockholders' equity		(5.4)
Total liabilities and equity		186.2

9.7.5 A summary for some countries

By combining the arrangements for institutions, for providing and for funding, a very varied picture emerges. Figure 9.3 shows the position for several countries. Eight types of scheme are shown in the figure, as are some countries where they are found.

9.8 Deferred tax

9.8.1 General explanation

The topic of deferred tax is one in which there have been major international differences in accounting. Deferred tax is not amounts of tax bills which the tax authorities have allowed the taxpayer to postpone. Accounting for deferred tax is the recognition of the tax implied (but not otherwise included) by the numbers shown in the financial statements.

A simple example of deferred tax would occur in the context of the revaluation of fixed assets. Suppose that a Dutch company buys a holding of land for €3 million and then revalues it in the balance sheet from €3 million to €9 million. Suppose, also,

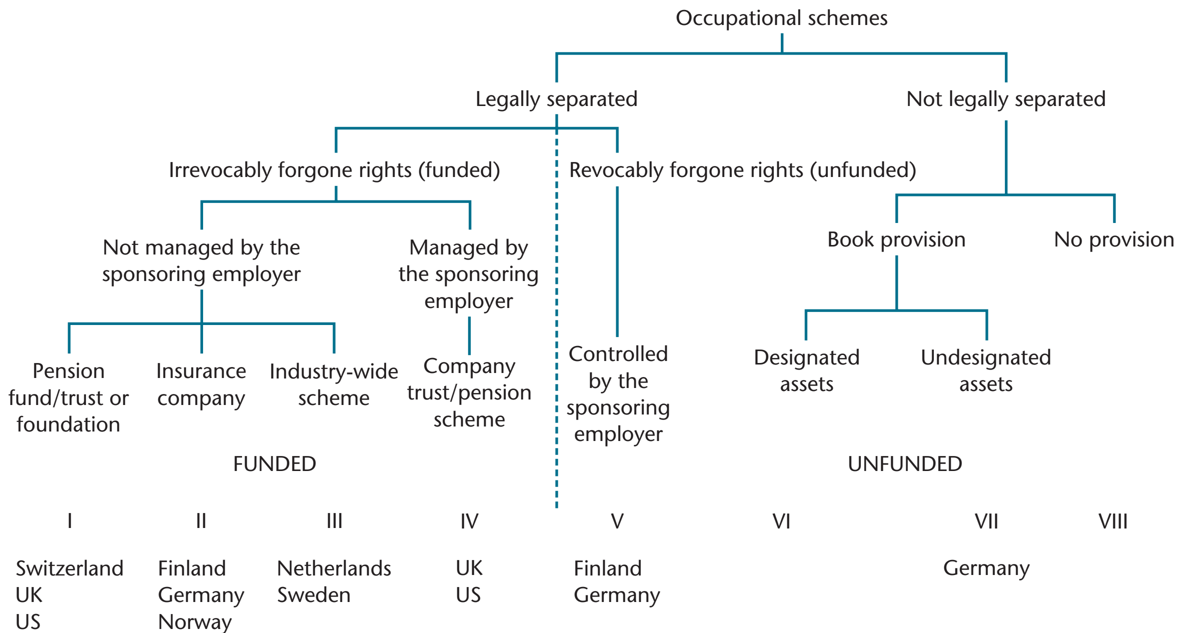

Figure 9.3 A classification of non-state pension schemes

Source: Adapted from FEE (1995) 'A classification of non-state pension schemes', in *Survey of Pensions and Other Retirement Benefits in EU and non-EU countries*. Routledge, London.

Table 9.6 Deferred tax on revaluation

Balance sheet adjustments for Dutch company (€ million)			
Land:			
cost	+ 3.0		
revaluation	+ 6.0		
	+ 9.0	Revaluation reserve:	+ 3.9
Cash:	−3.0	Deferred tax:	+ 2.1

that the Dutch corporate tax rate on capital gains is 35 per cent, but that the Dutch tax rules do not tax capital gains until disposal, which in this case is not intended by the company in the foreseeable future. No tax is payable as a result of revaluing, but it is possible to see how accountants might think that the potential liability to tax of €2.1 million (i.e. €6 million revaluation × 35 per cent) relates to the period up to the balance sheet date. If so, they account for the implicitly deferred tax in the balance sheet, as in Table 9.6. In the United States, where deferred tax accounting was invented, it was initially called 'inter-period tax allocation'.

In the above example, the €6 million of revaluation that is not yet relevant for tax purposes is called a 'temporary difference' under IASB or US rules. Under IAS 12 or US GAAP, enterprises are required to account for deferred tax on temporary differences at current tax rates. A temporary difference is the difference between the carrying value of an asset or liability for financial reporting purposes and its value as recorded in the tax records.

In the above example of the Dutch land, the financial reporting carrying value was €9 million and the tax value was €3 million. So, the temporary difference was €6 million.

Assuming that the land is accounted for under IAS 16, the revaluation gain is not recorded in profit or loss but in other comprehensive income (OCI). The same applies to the €2.1 million tax expense. So, net OCI is €3.9 million, which is shown in Table 9.6 as a revaluation reserve.

In the US, upward revaluation of land is not allowed (except in the context of consolidation; see below) but current valuations of certain securities are required (see 9.5.1). In several continental European countries, revaluation is legal under domestic accounting rules but would lead to current taxation. Consequently, in the individual financial statements of companies as prepared under the rules of most continental countries, deferred tax related to land would not arise, and the same applies to most accounting issues. However, particularly if a German or French (etc.) group is using IFRS rules in its consolidated statements, deferred tax could arise in these countries because accounting practices might depart from tax rules for revaluation and other reasons. Furthermore, under IFRS, US GAAP and most other national rules, when a subsidiary's assets and liabilities are first consolidated, they are brought in at fair values, which are not recorded in any tax records. These all create temporary differences.

The most common cause of substantial amounts of deferred tax liabilities in Anglo-Saxon countries is depreciation. Depending on the industry sector, depreciation can be a large expense, and the tax rules can be substantially different from the accounting rules, as outlined in Chapter 2. Table 9.7 sets out a simple case, where there are 100 per cent tax depreciation allowances in the year of purchase of plant and machinery; a 35 per cent corporate income tax rate; the purchase for €10,000 of a machine which is expected to last for five years; and a country where tax and accounting are separated. The existence of 100 per cent tax depreciation is not fanciful. This applied for all plant and machinery in the United Kingdom from 1972 to 1984, to certain assets in West Berlin until the end of the 1980s, to capital investments in certain Greek islands, etc. The example would work, of course, with the less extreme tax allowances that are still common in continental Europe.

In Table 9.7, suppose that the accountants assume that the asset will have no residual value and will wear out evenly over time, irrespective of use. Consequently, for accounting purposes, they charge a depreciation expense of €2,000 per year. By contrast, the tax authorities allow an expense of €10,000 in the first year and, if the

Table 9.7 Depreciation and tax

Accounting records			Tax calculations			
Year	Depreciation	Net book value	Year	Expense	Tax book value	Tax reduction
1	2,000	8,000	1	10,000	0	3,500
2	2,000	6,000	2	0	0	0
3	2,000	4,000	3	0	0	0
4	2,000	2,000	4	0	0	0
5	2,000	0	5	0	0	0

company takes this, no tax deductible expense after the first year. Consequently, there is a reduction in the tax bill of €3,500 in year 1 (i.e. an extra tax-deductible expense of €10,000 at a tax rate of 35 per cent). This cash flow advantage is designed to be the incentive to invest.

Suppose that the company uses the new asset very inefficiently or does not use it at all in the first year. In this case, depreciation may still be charged because the asset is depreciating due to the passing of time. The net effect of the inefficient capital purchase on the post-tax accounting profit of year 1 appears to be that the profit increases by €1,500 (i.e. depreciation expense of €2,000, and tax reduction of €3,500). Of course, if the company uses the asset effectively, profit will increase by much more than this, as the company should at least be able to earn enough by using the asset to cover the depreciation on it.

The above strange effect on profit is caused by deliberately charging the depreciation expense slowly but taking the tax reduction immediately. However, so far no account has been taken of deferred tax. In order to do so, under IAS 12 or US rules, it is necessary to calculate the temporary difference. This, as explained earlier, is the difference between the financial reporting carrying value of the asset and its tax value. In the case of the depreciating machine at the end of year 1, the financial reporting carrying value is cost less depreciation = €8,000, whereas the tax value is zero because there is full depreciation for tax purposes. So, there is a temporary difference of €8,000 and (at the tax rate of 35 per cent) a deferred tax liability of €2,800.

The double entry to give effect to deferred tax accounting in this case would be a debit entry under 'Tax expense' of €2,800, and a credit entry under 'Deferred tax liability' of €2,800. Then the profit for year 1 would *decrease* by €1,300 as a result of buying the asset and not using it (i.e. an extra depreciation expense of €2,000, an actual tax reduction of €3,500, but a deferred tax expense of €2,800). This is seen by most standard-setters as a more reasonable profit figure to present.

We have now seen two examples of the possible causes of deferred tax: a revaluation of assets that is not taken into account by the tax system, and depreciation running at a faster rate for tax than for financial reporting. Other examples include:

- the capitalization of leases, if the tax system still treats them as operating leases;
- taking profits on long-term contracts as production proceeds, if the tax system only counts profits at completion.

In order to account for deferred tax under IFRS and US rules, it is necessary to look at the values of all the assets and liabilities in the balance sheet and compare them to the tax values that would apply. Large numbers of temporary differences and resulting deferred tax assets and liabilities can arise. It is not allowed to discount the amounts to take account of the timing of the realization of the assets and liabilities.

We can summarize the above by quoting the accounting policy note of any IFRS or US company. Here is the policy of Electrolux, a Swedish group using IFRS:

> Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements . . . Deferred taxes are calculated using enacted or substantially enacted tax rates by the balance sheet date. Taxes incurred by the Electrolux Group are affected by appropriations and other taxable or tax-related transactions in the individual Group companies. They are also affected by utilization of tax losses carried forward referring

> to previous years or to acquired companies. This applies to both Swedish and foreign Group companies. Deferred tax assets on tax losses and temporary differences are recognized to the extent it is probable that they will be utilized in future periods. Deferred tax assets and deferred tax liabilities are shown net when they refer to the same taxation authority and when a company or a group of companies, through tax consolidation schemes, etc., have a legally enforceable right to set off tax assets against tax liabilities.

The IFRS/US rules have changed considerably over time, and the rules vary internationally. For a review of these developments, see Schultz and Johnson (1998). One major question is whether deferred tax 'liabilities' are liabilities at all: is there an obligation to pay tax merely as a result of choosing to revalue an asset in a consolidated balance sheet (Nobes, 2003, Chapter 4)? One possible conclusion is that deferred tax should not be accounted for at all (Weetman, 1992).

9.8.2 Deferred tax assets

The recognition of deferred tax can lead to assets as well as to liabilities. Two of the major causes of deferred tax assets are:

- losses carried forward for tax purposes to be set against future taxable profits;
- employee benefit obligations that have been recognized for financial reporting purposes but not yet for tax.

As an example of the potential importance of deferred tax assets, Table 9.5 showed a summary of the balance sheet of General Motors for 2006. The deferred tax asset ($44.9 billion) resulted partly from the unfunded pension ($11.9 billion) and health benefit ($50.1 billion) obligations, multiplied by the tax rate. It should be noted again that the company's net assets (= stockholders' equity) was negative for 2006 and was only $14.7 billion for 2005.

Under US and IFRS rules, deferred tax assets should be recognized when eventual realization is more likely than not. In the case of General Motors, by 2006, two years of losses were being shown in the income statement, so it was increasingly hard to believe that the deferred tax asset would lead to future benefits. Indeed, by the 2007 balance sheet, after a third year of losses, the company had reduced the deferred tax asset to less than $2 billion, helping to create a very large negative net assets figure.

Another common cause of deferred tax assets (including in General Motors) is unrelieved losses that can be carried forward. However, for these there must always be doubt about realization because future profits are needed.

9.8.3 Some international differences in deferred tax

In the domestic rules of several countries there are no requirements to account for deferred tax, partly because few temporary differences arise. The EU Directive does not generally require the recognition of deferred tax, only that which arises as part of the process of consolidation (Art. 24 (13) in the 2013 version).

Some countries (e.g. Norway) have similar rules to those of IFRS/US that were explained above. The rules in some others (e.g. France and the Netherlands) differ mainly in that deferred tax balances are sometimes discounted. In German and UK domestic rules, deferred tax is recognized not on temporary differences but on timing

differences. The latter are measured on an income statement basis rather than by reference to assets and liabilities. Timing differences are a smaller category of things than temporary differences.

A further twist is that, in some countries (e.g. Italy and, until 2001, the United Kingdom), the recognition of deferred tax is partial in that it depends on whether payment of the amounts is likely or foreseeable. There is a long-running antipathy against the recognition of deferred tax *assets* in many countries.

Some researchers have used the amounts of deferred tax recorded by listed companies as one measure of accounting quality in a country (e.g. Atwood *et al.*, 2010). More deferred tax implies greater separation of financial reporting from tax, which implies better reporting. Atwood *et al.* find that Canada, South Africa, Germany and the USA has the largest amounts of deferred tax of 33 countries in the period 1992 to 2005. This is a surprising result for Germany (see Chapter 2), but can be explained by the fact that most of the German companies in their sample were using international standards.

9.9 Measurement of liabilities

A number of different types of liabilities have been discussed in this chapter:

- amounts prepaid by customers on contracts (9.2);
- financial liabilities (9.5.2);
- provisions (9.6);
- pensions (9.7);
- deferred tax (9.8)

The measurement bases used for liabilities under IFRS comprise an interesting mixture, as shown in Figure 9.4.

There has been academic debate about the ideal measurement basis for liabilities. For example, Horton *et al.* (2011) recommend the liability equivalent of deprival value (see Section 9.4), which is usually the current equivalent proceeds (i.e. the amount that an entity could raise now by accepting the liability). Nobes (2011) summarizes the various bases, and proposes cost of performance (discounted cash outflows). McGregor (2013) argues in favour of fair value. Another possible basis is shown in Figure 9.4: cost of release. This is not required in any standard, but is the amount that the creditor would require to cancel the obligation. It might be relevant in litigation. Barker and McGeachin (2013) try to explain why IFRS contains inconsistent bases.

9.10 Comprehensive income

Beginning in the UK in 1993 (with FRS 3), standard-setters have gradually ensured that all gains and losses are recorded in a primary statement of income rather than any of them being lost as 'reserve movements'. The UK statement was called a 'statement of total recognized gains and losses' (STRGL), which included the profit from

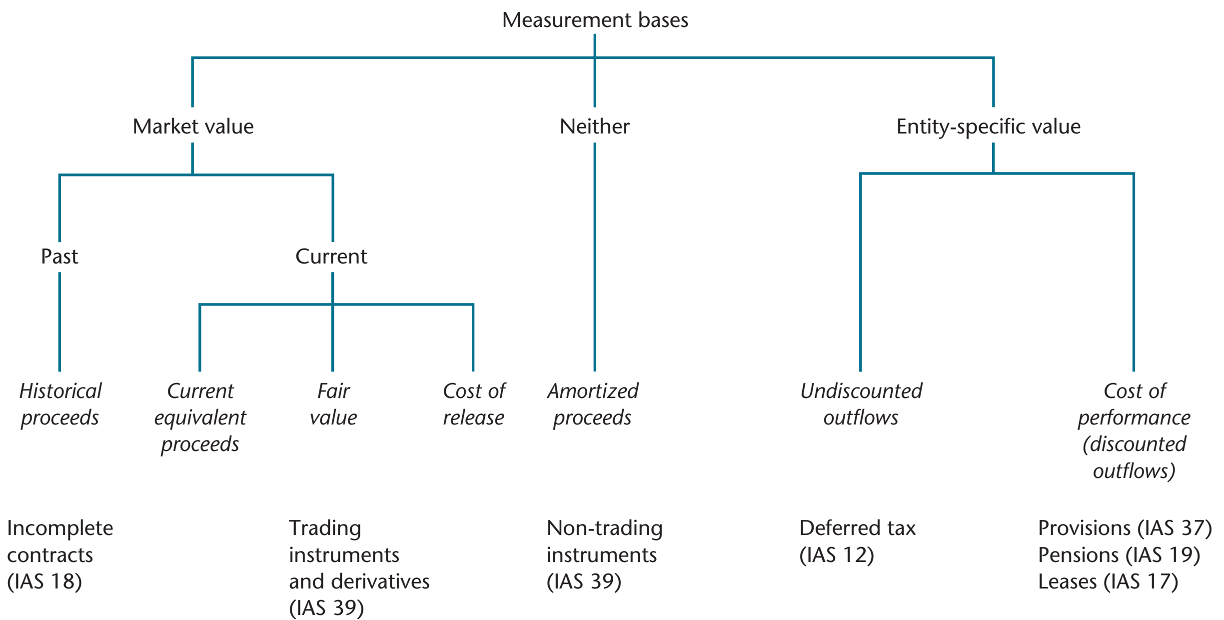

Figure 9.4 **IFRS measurement bases for liabilities**

Table 9.8 **Reporting of OCI (US companies), 2009**

	% of companies
Included in statement of changes in equity	81.0
Separate statement of comprehensive income	15.2
Combined statement of income and comprehensive income	2.2
No comprehensive income shown	1.6
	100.0

Source: American Institute of Certified Public Accountants (AICPA) (2010) *Accounting Trends and Techniques* (issued annually). AICPA, Jersey City, New Jersey, p. 425.

the bottom of the profit and loss account and then all other gains and losses. These latter are now called 'other comprehensive income' (OCI) in IFRS and US GAAP and, from 2013, they must be included in the 'statement of profit or loss and other comprehensive income', which can be (and nearly always is) split into an income statement and OCI. In US GAAP, the amounts of OCI could, until 2013, be included in the statement of changes in equity, and this was the most common practice, as shown in Table 9.8 for 500 US companies in 2009. As noted in Chapter 8, Bamber *et al.* (2010) suggest some reasons for this, related to avoiding volatility of earnings.

Table 9.9 shows the required statements under IFRS and some national rules in 2012. The reason for the three 'no' is that the options in US GAAP meant that none of the three were individually required, although some form of income statement was required.

Table 9.9 Required statements, 2012

Statement	Required in:			
	IFRS	US	UK	France/Germany
Separate income statement (or profit and loss account)	No	No	Yes	Yes
Separate STRGL or OCI	No	No	Yes	No
Comprehensive income, shown in single statement or two	Yes	No	Yes	No
Statement of changes in equity	Yes	Yes	No	No

Under IFRS, the components of other comprehensive income are:

- revaluations of assets (under IASs 16 and 38);
- fair value adjustments on available-for-sale financial assets (under IAS 39, or equivalently under IFRS 9);
- gains and losses on cash flow hedges (under IAS 39 or IFRS 9);
- actuarial gains and losses (under IAS 19); and
- foreign currency gains and losses on translation of financial statements (under IAS 21 – see Chapter 17).

All of these, apart from the first, are also relevant under US GAAP. All, apart from the last, have been discussed in this chapter. IAS 1 requires an entity to show the tax related to each component of OCI.

There is no principle that can explain why the above components are not included in 'profit or loss'. They all meet the definitions of 'income' or 'expense'. The explanation is *not* that they are 'unrealized', because gains on unsold investment properties or forests *are* included in profit or loss under IASs 40 and 41. Anyway, the concept of 'realized' does not appear in IFRS, and its meaning is unclear in EU laws. Incidentally, 'earnings' (as in earnings per share or the price/earnings ratio) is before any items of OCI.

The IASB has been trying to find a principle to classify income, but has not yet succeeded. The exposure draft for revision of the conceptual framework (IASB, 2015) suggests that 'profit or loss' is the primary measure of an entity's performance of the period.

A related issue is whether gains and losses, once recorded in other comprehensive income, are ever reclassified as profit or loss. This issue was introduced in Chapter 8, and an expanded version of Table 8.6 is shown here as Table 9.10. It reveals another set of rules for which no principle can be discovered. The political explanation is that standards influenced by the US require reclassification, whereas those influenced by the UK do not. Both IFRS and US GAAP require companies to show any amounts reclassified as profit or loss in the year and to show which amounts of the year's OCI that will later be re-classified.

Although IFRS and US GAAP now require all forms of income to be shown in a statement of income, there remain ways of postponing income. There have still been cases where items are recognized as liabilities even though they do not meet the

Table 9.10 Are gains and losses previously recorded as 'other comprehensive income' later reclassified as profit or loss?

	IFRS	US	UK
Revaluation of tangible and intangible assets	No	N/A	No
Fair valuing available-for-sale financial assets	Yes	Yes	N/A
Gains and losses on cash flow hedges	Yes	Yes	N/A
Actuarial gains and losses	No	Yes	No
Translation of foreign statements	Yes	Yes	No

Notes: *Standards for unlisted companies, in 2014.
N/A = Not applicable because not allowed or not covered by standards.

framework's definition. For example, negative goodwill has sometimes been stored as a reserve which is gradually shown as income (see 8.7.3) and sometimes stored as a negative asset (whatever that might be, this was the treatment under UK GAAP until 2014); although now under IFRS 3 it is treated as income immediately. Under IAS 20, government grants can be shown as a sort of liability ('deferred income') until they become income, although under IAS 41 (in the context of biological assets) they are income immediately.

SUMMARY

- The recognition of revenue is the topic of a major new standard, jointly issued by the IASB and the FASB. 'Revenue' is defined confusingly by the IASB.
- Intangible assets are very important in many fast-growing companies. Recognition of them varies between IFRS and US rules.
- The measurement of assets is mostly based on cost under US GAAP, but IFRS allows many departures from this.
- In most countries, but not in IFRS, the classification of financial instruments is based on legal form, and discounting of liabilities is unusual.
- Financial assets are divided into three types, based on management's intentions. In 2008, in the context of financial crisis, the IASB amended IAS 39 to allow re-classification out of the trading class.
- Hedge accounting is permitted under some circumstances in IFRS and US GAAP.
- The degree to which provisions are recognized for future expenses varies internationally. Under IFRS, an obligation must exist at the balance sheet date.
- Care needs to be taken when translating such terms as provision, reserve, allowance and fund.
- The institutional arrangements for post-retirement benefits vary from country to country. Accountants need to identify the degree to which a company has obligations.

- IFRS contains several devices to protect profit or loss from the volatility caused by actuarial gains and losses.
- Pension funding arrangements also differ, with full funding often found in the United States and the United Kingdom but not in continental Europe.
- The IFRS/US rules use a balance sheet basis for deferred tax calculations (temporary differences), whereas some other rules use an income statement basis (timing differences).
- Deferred tax liabilities may be caused by accelerated tax depreciation and by the revaluation of assets.
- There are international variations in the use of discounting for deferred tax balances and in the degree to which all temporary/timing differences are accounted for.
- There are no principles to explain which income and expense is 'other comprehensive income' or which parts of that should be later re-classified as profit or loss.

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

9.1* 'Secret reserves make a company stronger, so they should be encouraged.' Discuss.

9.2* Under IAS 32, some shares are treated as liabilities and some apparent liabilities are treated as partly equity. Is this a good idea?

9.3 Under what circumstances should next year's wages and next year's repair expenses be charged as expenses this year?

9.4 Are intangible assets recognized sufficiently under IFRS and US rules?

9.5 Explain how assets are measured under IFRS. How could this be improved?

9.6 Explain the difference between 'hedging' and 'hedge accounting'. In each case, what are the arguments in favour of doing them?

9.7 Explain the differences between an allowance, a liability, a contingent liability, an obligation, a provision, an accrual, a fund and a reserve. State which set of accounting rules you have been using as the context for your answer.

9.8 Compare the degrees of prudence found in accounting for employee benefits in Germany, Italy and the United States.

9.9 Explain, using various examples, the causes of deferred tax assets and deferred tax liabilities under US accounting rules.

9.10 Examine whether a deferred tax liability arising from temporary differences on the revaluation of an asset meets the IFRS/US definition of a liability.

10 Political lobbying on accounting standards – US, UK and international experience

Stephen A. Zeff

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OBJECTIVES

After reading this chapter, you should be able to:

- define political lobbying;
- explain the motivations of companies and governments when they lobby standard-setters;
- give examples from several countries of political lobbying in the context of particular standards;
- give examples of lobbying concerning the structure of a standard-setting body;
- explain why some standard-setters are more subject to lobbying than others.

10.1 Introduction

Standard-setters, such as the IASB, the US FASB and the UK Accounting Standards Board (ASB), have committed themselves to act in the interests of investors (not of companies or auditors), to use conceptual frameworks (see, for example, Section 8.4) and, recently, to converge their standards. But there is a challenge: political lobbying driven by preparer or governmental self-interest. This may cause the standard-setters to modify their positions and run the risk of diluting or abandoning the principles implicit in their standards.

The term 'economic consequences' has been used to describe the 'impact of accounting reports on the decision-making behaviour of business, government, unions, investors and creditors' (Zeff, 1978). Those who have a vested interest in how this decision-making behaviour is conducted will place pressure on the standard-setter not to approve the standard containing an objectionable feature. This is lobbying, and it includes writing letters or giving oral testimony at a hearing arranged by a standard-setter to expose its tentative views to public comment. 'Political lobbying' goes beyond that, and the term is used here to describe concerted campaigns of action against a proposal, where the lobbyists make overt or covert threats to seek intervention to overturn a proposed standard or to compromise the standard-setter's reputation, independence, powers or even its existence.

Pressure induced by political lobbying might constitute threats to withdraw funding or other vital support for the standard-setter, or appeals to public opinion by carrying the dialogue into the public media. In recent decades, the pressure brought by preparers has escalated to a more intimidating level: engaging the active support of the executive and legislative branches of government. We have seen this development most particularly in the United States, but also in Europe over IAS 39 on financial instruments.

Political lobbying on proposed accounting standards has been a long-standing phenomenon in the United States (e.g. Sutton, 1984). However, other standard-setters have faced such lobbying, and recently the IASB faced lobbying on the subjects of accounting for share-based payment and financial instruments, and it seems likely to also intrude on the future standards dealing with accounting for pensions, insurance, leases and performance reporting. The IASB Chairman, referring to the likely reaction by preparers to the board's initiatives on these topics, has been quoted as warning that there could be 'blood all over the streets' (Tricks and Hargreaves, 2004).

In what circumstances does political lobbying emerge as an issue for standard-setters? The answer to this is principally in situations where the standard-setter proposes to issue a standard on a topic not previously covered, or to eliminate or sharply reduce optional accounting treatments in an existing standard, and where a regulatory body will intervene to secure strict compliance with the standard. The likelihood of political lobbying would increase in some countries if the proposed standard were either to lower companies' earnings or make their trend of earnings more volatile. This has occurred especially in the case of banks and other financial institutions. In other countries where profits[1] are linked with tax on a company's income, such as in

[1] In particular, this refers to profits as prepared under national rules in the financial statements of individual entities.

Germany, companies lobbied against any measures in the German implementation of the EEC's Fourth Directive that would *increase* their earnings (Ordelheide, 1993, page 87; von Wysocki, 1984, page 58; McLeay, Ordelheide and Young, 2004).

The task for the standard-setter is to determine when, and to what extent, political lobbying raises valid issues which, in the light of its conceptual framework, require attention in the fashioning of a standard, and when it does not. Not all of the examples presented later in this chapter are of the latter kind.

After this introduction, the chapter looks (in Section 10.2) at the motivations for political lobbying. Section 10.3 then examines examples of lobbying of standard-setters up to 1990. That year is chosen as a boundary because of the increasing incidence of standard-setters' advocacy of fair value accounting, a controversial issue, in the United States and the United Kingdom and at the IASC, during the 1990s. Also, in the United Kingdom, the ASB replaced the Accounting Standards Committee (ASC) in that year.[2] The examples depend on the availability of evidence. They are drawn from the United States and the United Kingdom because these countries had (and have) the largest number of listed companies, well-established private-sector standard-setters, and the best documented examples. A few documented instances of political lobbying can be found elsewhere. For example, Germany is mentioned above. Also, Zeff and Johansson (1984) report on parliamentary meddling in standard-setting in Sweden in 1977. Crandall (1983) and Scott (2003, page 270) report on the failure of lobbying in Canada in 1982 concerning the accounting treatment of grants in the oil industry.

Section 10.4 looks at national political lobbying from 1990 onwards. All the examples are from the United States. There are few well-documented cases of political lobbying of national standard-setters outside the United States from 1990 onwards. This might be partly because the United Kingdom's ASB was more independent than its predecessor (Swinson, 2004). In contrast, the international standard-setter was becoming more important during the 1990s and beyond (see Chapter 4), and therefore more prone to lobbying. Section 10.5 looks at political lobbying of the IASC/IASB.

Lobbying can also concern attempts to change the structure or mode of operation of the standard-setter. Section 10.6 examines examples of this relating to the FASB and the IASB.

The new millennium is also a new era of standard-setting in the sense that there are now *two* superpowers rather than just one: the IASB has joined the FASB. Section 10.7 considers political lobbying of the FASB's attempts to converge with the IASB's standards. Section 10.8 offers some concluding remarks.

10.2 Motivations for political lobbying

Why do preparers and governments engage in the political lobbying of accounting standard-setters? For listed companies operating in major capital markets, there are several motivations, mostly related to the revenue and earnings pressures on top

[2] In 2012, the Accounting Standards Board was succeeded by the Accounting Council, also an entity within the Financial Reporting Council.

management. Company managers are 'held to account' by securities analysts whose publicly announced earnings forecasts raise the bar for the performance measures in companies' quarterly, semi-annual and annual reports to shareholders. If a company were to announce much higher earnings, which fall short of the forecast figure, its share price might be badly affected. For example, HSBC Holdings, the world's third biggest bank, announced its pre-tax profit for 2010 that was up by 169 per cent over its comparable figure for the previous year. Yet, when this profit fell short of analysts' forecasts, the company's share price dropped by 5 per cent on the announcement date (Wardell, 2011). In order to avoid suffering such impacts on their company's share price, top company executives wish to retain as much flexibility as possible over the 'management' of their earnings. Such flexibility also applies to managing their reported revenues, which are a key market indicator. When standard-setters propose to limit this flexibility, company managements – the preparer sector – resist with the considerable power at their disposal.[3]

The same perceived need to manage earnings arises when a company seeks to engineer a hostile takeover or is itself the object of an unfriendly takeover, each party wishing to persuade the object's shareholders that its earnings record is the superior one. The merger movement was particularly strong in the 1960s and again from the 1980s to the present.

In an active market for chief executive officers, it is a natural desire for them to flaunt their credentials as successful managers; and a record of lifting the revenues and earnings of a major company, or of maintaining a record of smoothed and growing earnings, helps their reputations. Again, top executives are motivated to build their company's revenue and earnings, and any initiative by a standard-setter that would diminish top executives' flexibility to manage these figures would be opposed.

Another motivation relates to how managers are compensated. Increasingly since the 1980s, top executives have been showered with bonuses based on earnings and with stock options whose value, it is widely supposed, is enhanced by a solid record of earnings. When executives sense that standard-setters might alter accounting in such a way as to endanger the munificence of their compensation package, they fight the change fiercely.

Very large companies that are regulated or subject to pressure from politicians (e.g. anti-trust actions) might well seek to ward off intervention in their affairs by lobbying for a standard that lowers their earnings, in order not to attract undue attention from government.[4]

When company executives register objections to standard-setting initiatives, especially when complaining to the legislative or executive branches of government for relief, they do not, of course, cite self-serving reasons to support their cause. And when dealing with legislators, they do not argue in terms of accounting issues. Legislators and their staff typically know nothing, and could not care less, about accounting standards. Instead, the preparers elevate the discourse to the level of public policy, claiming, for example, that the proposed initiative would stifle entrepreneurial

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[3]A substantial empirical research literature supports the view that companies manage earnings. See, for example, Burgstahler and Dichev (1997) and Nelson *et al.* (2003). Also see the major speech by SEC Chairman Arthur Levitt, 'The "Numbers Game"' (28 September 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt, as well as Bruns and Merchant (1990), Dechow and Skinner (2000) and Duncan (2001).

[4]For evidence in support of this thesis, see Watts and Zimmerman (1978).

activity or could make it harder for established companies to expand and thrive by obtaining sufficient capital based on a promising record of revenues and earnings. When the banking community feels under threat by a standard-setter, it argues that a proposed accounting standard would project an image of instability in the banking system and might restrict the availability of credit. The standard might even force regulators to close some banks, because the balance of capital in their financial statements is below the solvency line. When their arguments are expressed in terms of public policy, preparers can more easily obtain a sympathetic hearing from legislators and others in government.

Governments have also engaged in political lobbying on proposed accounting standards. If it is believed that a proposed standard would lead to companies reporting lower or more volatile earnings, they might abandon plans for expansion by withholding investment in capital goods. A result of such a decision might be a rise in unemployment and perhaps even the closing of plants, which a government may wish to avoid at all costs, especially when the national economy is recovering from a recession.

The economic and financial crisis which began in 2008 exacerbated pressures on standard-setters, as prudential regulators and politicians ostensibly concerned about the plight of banks descended on both the IASB and the FASB for accounting relief (see Howieson, 2011).

One can easily discern from this discussion that accounting has become a pawn in a game of political chess. Using an analogy from sports, 'the way you score a game determines the way the game is played'. The nature of the scoring system influences behaviour. If, in football (called 'soccer' in the United States), it is decided that the outcome of matches with tied scores at the end of regulation play will be determined by the side having the larger number of corner kicks (as has been proposed), teams will modify their strategy to maximize the opportunities for corner kicks. In basketball, the scoring change that created the three-point line has motivated many players to shoot from the outside. Accounting scores the game of enterprise and, when the accounting rules change, those who run enterprise are motivated to change their managerial behaviour so as to restore or enhance a company's previous record of reported revenues and earnings. Those who want to change the way enterprise is conducted may find it much easier to alter the accounting rules than to try to persuade all company managers to change their behaviour.

10.3 Political lobbying up to 1990

10.3.1 The United States[5]

Examples of an appeal to 'economic consequences' or even attempts to bring political pressure on accounting standard-setters can be found at least as far back as the 1940s. This occurred in the United States before other countries for at least

[5]Readers seeking a comprehensive review of the political origins and other explanations of US GAAP, from the 1930s to the 2000s, are invited to consult Zeff (2005). Online access to this article in *The CPA Journal* is free of charge.

two reasons. First, the United States was among the very first countries to have an accounting standard-setter, and especially one that was trying to come to grips with diverse accounting practice. Secondly, the United States has a rigorous securities market regulator, the SEC. Since its establishment in 1934, the SEC has regularly taken strong measures to prevent listed companies from deviating from GAAP (for a discussion of this role played by the SEC, see Zeff (1995)). As there is usually little to be gained by arguing with the SEC, which, except in rare instances, is obdurate in not tolerating such departures, companies disliking a proposed accounting standard know that they must do battle with the standard-setter instead. No other country's securities market regulator possesses either the authority or the staff to ensure such strict compliance with its national GAAP. Consequently, the US accounting standard-setter has been beset by insistent demands from the preparer sector not to change accounting standards in a way that damages their perceived interests. In some instances, the preparer community urges the standard-setter to modify an existing standard, because changing economic circumstances would enable companies, by use of the changed standard, to present their financial results in a more favourable light.

The effects of the post-war inflation (1947–9)

An interesting appeal to 'economic consequences' occurred in the late 1940s, during the serious bout of inflation of the post-war period. A number of major manufacturing companies, such as Chrysler, US Steel and Du Pont, wanted to record depreciation expense for accounting purposes at replacement cost rather than at historical cost, which was the only method allowed under GAAP. Basing depreciation expense on historical cost, which reflected the much lower pre-war prices of property, plant and equipment, was said to overstate the companies' earnings, often by a very large fraction. Depreciation was one of the largest items of expense for manufacturing companies. The companies' argument could be justified by accounting principles because of the mismatching of old dollar costs with new dollar revenues, yet the SEC and therefore the standard-setter were unflinching in their defence of historical cost accounting.

As companies saw it, an overstatement of earnings would encourage aggressive labour unions to press for higher wages and fringe benefits (such as pensions), and shareholders would demand larger dividends. Worse, the country's press would accuse the giant companies of profiteering against the best interests of the public in an already inflationary economy. Should the standard-setter try to alleviate the effects of these possible consequences? Another motivation of management was to seek Congressional approval to use replacement cost depreciation for federal income tax purposes, because the companies were convinced they were being taxed on capital. If the companies could persuade the accounting standard-setter to recognize replacement cost depreciation in their financial statements, they hoped to have success when urging an income tax reform along similar lines. In the event, neither the standard-setter nor Congress accepted the companies' argument.

There is no evidence that the companies put political pressure on the standard-setter, but this was one of the earliest concerted attempts to link accounting measurements with their possible economic consequences (Zeff, 1993).

The three stages of the investment tax credit (1962–71)

Perhaps the most celebrated early case of political lobbying in the setting of accounting standards occurred in three stages between 1962 and 1971. In 1962, the federal government introduced an 'investment tax credit' to stimulate the purchase of capital goods at a time of economic malaise. In its simplest form, the credit allowed a company purchasing, say, $1,000,000 of equipment or machinery to deduct 10 per cent of the purchase price as a credit against its current year's income tax liability. But how should the $100,000 be accounted for in the company's financial statements? Two competing schools of thought immediately emerged: the 'flow-through' method and the 'deferral' method. Advocates of the flow-through method argued that the $100,000 credit against taxes should be taken immediately to earnings, an approach favoured by companies that were looking for any way to boost their reported earnings. Proponents of the deferral method argued, however, that a company makes a profit by selling, not by buying. They contended that the $100,000 was, in reality, a government subsidy that should be subtracted from the purchase price for accounting purposes, and the netted purchase price of $900,000 should be treated as the effective cost of the asset, to be depreciated for financial reporting purposes over the useful life of the asset. The 20-member APB, the accounting standard-setter at the time, was riven by disagreement over which method should be accepted. The Big 8 accounting firms split 4–4 in the final vote, which, by an overall vote of 14–6, imposed a requirement to use the deferral method, under which companies must subtract the tax credit from the purchase price of the asset. The APB, by just achieving the required two-thirds majority, therefore rejected the inclusion of an option to take the tax credit immediately to earnings.

Companies made it known that they opposed the APB's decision and, behind the scenes, the Administration of President John F. Kennedy argued that the requirement to subtract the tax credit from the purchase price of the asset for accounting purposes would lead companies to report lower earnings and thus be less keen to purchase capital goods and thereby expand employment. Hence, for reasons of macroeconomic policy, the Administration urged the SEC to allow both treatments. A significant number of company managements and several of the dissenting Big 8 accounting firms also entreated the SEC not to sustain the APB's opinion. In the end, probably because of the pressure brought by the Administration, the SEC announced in January 1963 that it would allow companies to use either the flow-through or deferral method. This rebuff came as a shock to the APB, which the SEC had been pressuring to 'narrow the areas of difference' in accounting practice. In the case of the tax credit, the APB had earnestly and with great difficulty settled on only one permissible method, yet the SEC overruled it and allowed both methods.

It was not publicly known at the time that political lobbying had prompted the SEC's surprising authorization to allow both treatments. The APB assumed that the SEC disagreed with it over which was the superior accounting treatment. In the end, the SEC embarrassed the APB by not backing it up, but it was not until 1967 (see below) that the APB actually learned why the SEC had overruled it. By 1964, fully three-quarters of major companies opted to take the tax credit immediately to earnings. For fuller discussions, see Moonitz (1966), Keller and

Zeff (1969, pages 417–20), Horwitz and Kolodny (1982, pages 95–7), and Seligman (2003, pages 424–5).

The issue of the proper accounting treatment of the investment tax credit arose a second time, in 1967. In that year, the APB proposed once again, with apparent support from the SEC, to require that the investment tax credit be subtracted from the purchase price of the asset. But then the Assistant Secretary of the Treasury (Tax Policy) stated his view publicly that 'a mandate to defer the benefit arising from the investment credit could well blunt its effectiveness as an incentive to modernization and expansion'.[6] Once it became known that the Treasury stood against the APB's proposed standard, the SEC withdrew its support. The APB thus learned that it was the Treasury, not the SEC, which was pulling the strings, and for political and not technical accounting reasons.

The matter came up for a third time, in 1971, when the Administration of President Richard M. Nixon introduced a 'job development credit', which was the old 'investment tax credit' dressed up in new clothes, to emphasize its potential to increase employment. After the APB again issued an exposure draft proposing a requirement that the credit be subtracted from the purchase price of the asset, the Treasury took definitive action to counter its move. In the draft of its proposed legislation to enact the job development credit, the Treasury stipulated that taxpayer companies, in their financial statements filed with the SEC, would be entitled to use *any* method of accounting for the credit they preferred. Congress passed the legislation, which was promptly signed into law by the President (see Zeff (1972, pages 178–80, 201–2, 219–21) and Zeff (1993)). The APB was therefore powerless, as was the SEC, being a creature of Congress. It was not until 1986 that Congress repealed the tax credit.

The three incidents involving the tax credit, especially the first and third ones, received extensive coverage in the financial press, and these news reports and editorials probably served to alert company executives to what could be achieved by lobbying the accounting standard-setter on political grounds.[7]

Business combinations (1968–70)

At the end of the 1960s, US industry and government both applied pressure on the APB from different directions, forcing it to issue a highly compromised standard on business combinations. Industry strongly opposed the elimination of 'pooling of interests' accounting, which was the APB's initial position, whilst government believed that its elimination might usefully slacken the pace of a merger movement that seemed to be getting out of hand. The Financial Executives Institute blanketed the nation's press with news releases criticizing the APB, and its Corporate Financial Reporting Committee urged Financial Executives Institute (FEI) members to:

[6]Stanley S. Surrey, letter to AICPA re exposure draft of APB Opinion on Accounting for Income Taxes, dated 7 November 1967, reproduced in Keller and Zeff (1969, page 449).
[7]See, for example, 'A Matter of Principle Splits CPAs', *Business Week* (26 January 1963), pages 50ff.

> contact your outside auditors and request a meeting with the senior partners to discuss your views on the proposed [APB] opinion, and also [the committee] strongly recommends that you seek to determine the position your audit firm is taking on this issue.[8]

This was a brazen attempt to apply pressure on the Big 8 audit firms, all of whom had a partner serving on the APB. As seen by the Big 8 firms, a decision to vote against the wishes of their major audit clients could place future engagements at risk. In the end, principle was thrown to the winds, as the APB was barely able to muster the required two-thirds majority to issue a flawed Opinion No. 16 which did not eliminate pooling (Chatov, 1975, Chapters 13 and 14; Seligman, 2003, pages 419–30; and Zeff, 1972, pages 212–16).

Petroleum exploration costs, marketable securities and leases (1971)

There were other such examples of political lobbying during the tenure of the APB (1959–73). In 1971 it scheduled three public hearings to consider accounting for petroleum exploration costs, marketable securities, and long-term, non-cancellable leases in the accounts of lessees. The petroleum industry used its might to prevent the APB from pursuing the treatment of exploration costs any further for the moment (see below) (Savoie, 1974, page 326). The mutual property and casualty insurance industry, which was opposed to the inclusion in earnings of the volatile unrealized holding gains and losses on their large portfolio of marketable securities, effectively prevented the APB from issuing even an exposure draft.[9] The leasing industry, which was making a handsome profit from bringing parties together that wanted to arrange long-term, non-cancellable leases of assets, such as aeroplanes or petrol (gasoline) stations, for which the lessee could avoid displaying the leased asset and liability on its balance sheet, fought off the APB's attempt to consider a preliminary draft *Opinion* on the matter. Capitalization of the leased asset and liability would adversely affect a lessee's return on investment and its debt–equity ratio, thus making the lease arrangement less attractive. To fight the APB, the leasing industry organized a letter-writing campaign addressed to key members of Congress so as to raise their ire towards the APB. The letters were sent by many constituents from all parts of the country, and quite a number stated that the APB was threatening to:

1. Raise the cost of electric power to the public by an estimated $550 million yearly towards the end of the decade.
2. Raise the cost of freight transportation to industry and the public.
3. Reduce the inventory of railroad cars and locomotives.
4. Increase the costs of air fares to the public.
5. Damage the aerospace industry.
6. Raise the costs of all goods and services to the public.

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[8] Letter stamped 'ACTION' from J.J. Hangen, Chairman of the FEI Corporate Reporting Committee, to FEI members, dated 15 October 1969.

[9] For further discussion, see Horngren (1973). The mutual property and casualty insurance industry objected to the inclusion of unrealized holding gains and losses in earnings because of the volatility it would create. Also, see Savoie (1974, page 326).

7 Prevent many small and growing businesses from acquiring modern cost-cutting machinery and equipment.

8 Negatively affect the present adverse international balance of trade. (See Zeff (1985), footnote 3 on page 24, and Savoie (1974, page 326)).

There was something in the letter to cause every member of Congress to hate the APB. The letters of concern from members of Congress, as well as from the Secretary of Transportation, forced the APB to close down its consideration of the issue of capitalizing leases in lessees' balance sheets altogether (Zeff, 2012). Politics had won again.

Segment reporting (1966–7)

When segment reporting became an issue during the 1960s, politics also intervened. During the decade, numerous mergers created conglomerate, or diversified, enterprises as well as multinational enterprises. As a result of the mergers, their operations spanned multiple product groupings and geographical regions, and Congressional policy makers could not determine whether the mergers raised anti-trust problems unless the merged companies were to disclose sales revenue and income by line of business. Companies opposed having to disclose the revenues and earnings associated with each of these major segments of their worldwide operations. One of their aims was to avoid 'tipping off' competitors that some of their product lines or geographical operations were especially profitable. The APB's attempt to issue a mandatory standard on segment reporting was frustrated by this political opposition. In the end, the APB could do no more than issue a non-binding statement in 1967.[10] Instead, the SEC issued its own 'line of business' reporting rules for companies in 1969.

Restructuring of troubled debt (1973–7)

From its foundation in 1973 onwards, the FASB also was besieged by political lobbying. During 1974–5, when the City of New York was found to be insolvent and defaulted on its long-term debt to banks across the country, the leaders of the banking community managed to restructure the City's debt by extending its maturities and reducing the interest rates. The question then arose in the minds of the FASB of how the banks should reflect this economic loss in their financial statements. The FASB held a public hearing in which it contemplated, as one solution, showing the loans receivable at market value, which meant that the banks would need to record significant losses in their own published financial statements. At the outset of the public hearing, Walter B. Wriston, the Chairman of Citicorp and the nation's leading banker, rose to make a statement that jarred the members of the FASB:

> If the banks that held the New York City obligations had been required to record an immediate write-off of say, 25 per cent of principal as a result of restructuring, that restructuring just might not have happened. Several of the banks whose cooperation was essential might

[10]See Zeff (1972, pages 202–4). For a discussion of the SEC's involvement in this controversy, see Seligman (2003, pages 430–8).

> not have been able to afford it, not from an economic point of view, but in terms of the way that readers of financial statements would interpret such charged earnings. Some New York banks were at that time under severe earning pressure and the prospect of a significant additional charge with a corresponding reduction in capital would have been totally unacceptable.
>
> Zeff (1985, page 25, footnote 4)

Should the FASB have insisted on an immediate write-down of the receivable in the banks' balance sheets and run the risk that any future such restructurings of the debt of defaulting cities or companies might thereby be jeopardized? In the end, the FASB 'pulled its punch' and did not require an immediate write-down of the receivable. The 'economic consequences' were, to the board, evidently overpowering. The board's Statement 15, finally issued in 1977 with two dissenting votes, is regarded by many as the worst it has ever issued. And the reason was politics (Zeff, 1993).

Petroleum exploration costs (1975–81)

A major political issue in the latter 1970s was accounting for petroleum exploration costs, a subject that the industry had succeeded in squashing in 1971, as noted earlier. The issue arose in the wake of the Arab Oil Embargo of 1973 and the US Government's need to develop a database for making national energy decisions. The Energy Policy and Conservation Act of 1975 instructed the SEC to establish uniform accounting standards for oil and gas exploration. Until then, most of the major producers were expensing the cost of dry holes (known as 'successful efforts costing'), while most of the small and medium-sized entities were capitalizing costs of all of the holes drilled (known as 'full costing'). The assignment given to the SEC was to establish a single method that all companies must use. As authorized in the 1975 Act, the SEC turned to the FASB for the development of a standard on which it might rely, and the board began its work in earnest. The FASB's exposure draft, issued during 1977, proposed successful efforts costing as the sole method to be used. This position so infuriated the small and medium-sized entities that they lobbied Congress to pass legislation that would preclude either the FASB or the SEC from eliminating full cost accounting as an acceptable method. A bill was drafted but, following negotiations with the SEC, it failed to gain passage (Gorton, 1991, page 32). This episode placed both the FASB and the SEC on notice about the lengths to which the powerful oil and gas industry would go to preserve its financial reporting options.[11] Nonetheless, the FASB issued Statement of Financial Accounting Standards (SFAS) 19, by a vote of 4–3, which eliminated full costing as an acceptable method.

Then the SEC held public hearings in Washington and Houston, taking thousands of pages of testimony. Companies opposing SFAS 19 embarked on a frantic campaign to prevent the SEC from enforcing the standard, and they enlisted the support of members of Congress from oil-producing states to write letters to the SEC. Small- and medium-sized entities feared the prospect of large year-to-year fluctuations in their earnings under successful efforts costing, with the result that banks and other capital suppliers might cut them off from needed finance. The Department of Justice and the Federal Trade Commission lent support to the companies' argument by alleging that

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[11]For a view from within the FASB at that time, see Staubus (2003, pages 185–7).

a requirement to adopt successful efforts costing would hamper their financing, and they raised fears that, as a consequence, small and medium-sized entities might have little option but to be merged into the major producers, thus reducing the number of competitors in the industry. This further concentration in the industry, they said, was not consistent with the government's anti-trust policy; therefore, they argued that full costing should be retained as an acceptable accounting method. The newly formed Department of Energy registered its opposition to SFAS 19, also for a reason having nothing to do with accounting:

> The Department of Energy argued that small companies, if they were forced to use successful efforts costing, would deliberately engage in less risky drilling, in order to dampen the amplitudes in their year-to-year earnings, which was contrary to the Department's evolving policy of encouraging the exploration for oil and gas in places where it had not been discovered before.
>
> Zeff (1993, page 138)

In this highly pressurized environment, the SEC decided instead that companies' proven oil and gas reserves should be reported in their financial statements at current value (known as 'reserve recognition accounting'), rather than be reflected at either successful efforts or full costing, which were predicated on the historical costs incurred. But then the major oil and gas producers complained aggressively that the use of reserve recognition accounting, under which unrealized holding gains and losses were to be taken to earnings, would, at a time when the OPEC cartel was regularly raising the price of crude, expose them to fierce criticism in the press and by the public for bloated earnings. The supply of petrol (gasoline) to consumers was severely restricted, and its price was, of course, steadily rising to unprecedented levels. Consumers were irate. This was not the time, the major producers argued, for them to be reporting record earnings quarter after quarter. Finally, buffeted by intense criticism and lobbying, the SEC instructed the FASB to develop a current-value footnote for oil and gas reserves, and all companies in the industry were once again authorized to choose successful efforts or full costing (Horwitz and Kolodny, 1982; Zeff, 1982, pages 39–44; Zeff, 1993, pages 137–40; Van Riper, 1994, chapter 4; pages 102–7; Miller *et al.* 1998, pages 125–7; Zeff, 2007, page 58; and Cortese, 2011). Politics was again the victor.

Other post-employment benefits (1987–90)

Although there were strong voices from the preparer sector foretelling disastrous consequences if the FASB were to require that a liability be placed on the balance sheet for the hitherto unrecognized cost of health benefits for all current and retired employees, the board nonetheless succeeded in doing so in SFAS 106, issued in December 1990.[12] This was an interesting case in which the preparer community failed to defeat a proposed standard. Previously, companies' health care costs were recorded as expenses when they were paid, not when they were accrued during employees' productive years of service. Employees and unions were worried that some companies, facing a mountainous liability in their balance sheets, might withdraw some health

[12] SFAS 106 formed part of the FASB's major project on pensions, which also produced SFAS 87, on employers' accounting for pensions.

benefits from employees or seek to renegotiate collective bargaining agreements. Two years before SFAS 106 was issued, it was reported that, as a result of such a standard, 'The data show that the companies' health costs [in their income statements] are likely to jump by three to six times, an explosion that in some instances will crater earnings' (Loomis, 1988, page 108; see also Dankner *et al.* (1989)). SFAS 106 allowed companies either to write-off the total unfunded obligation as a lump-sum expense, classified as a 'cumulative effect of an accounting change', in the year in which the standard was adopted, or to amortize it as an ordinary expense, usually over 20 years. The vast majority of the adopters chose the former option, perhaps believing that the market would pay little attention to a 'cumulative effect' disclosure of a one-time, non-cash expense. Older industrial companies' balance sheets were hit particularly badly. General Motors reported a 1992 after-tax charge of $20.8 billion, compared with 1991 year end shareholders' equity of $27 billion. Chrysler's after-tax charge exceeded the balance in its retained earnings. But the FASB was generally praised for forcing companies to account for the accrued cost of the health care benefits that they had awarded to employees, thus requiring them, many for the first time, to calculate and analyze the cost of the benefits conferred. SFAS 106 justly gave rise to the maxim 'you manage what you measure' (Loomis, 1988, pages 106, 108; Wyatt, 1990, pages 108–10; Miller *et al.*, 1998, pages 136–7).[13]

10.3.2 The United Kingdom

Beginning in 1970, with the launch of the United Kingdom and Ireland's first standard-setting committee, the Accounting Standards Steering Committee (ASSC), companies began to take the matter of accounting norms more seriously. This was the case even though there was effectively no one other than auditors to monitor on a continuing basis whether companies' financial statements gave 'a true and fair view' in accordance with the Companies Acts (see Chapter 14).

Inflation accounting (1971–5)

Political lobbying was evident in the attempt by the ASSC to set a standard on inflation accounting. At a time of rising concern over inflation, the ASSC in August 1971 issued a discussion paper, *Inflation and accounts*, in which it outlined an argument for the use of 'current purchasing power' (CPP) accounting. This meant an indexation of the financial statements for changes in the Consumer Price Index, in a supplementary statement to the annual accounts. This paper was followed up in January 1973 by the ASSC's exposure draft, ED8, which proposed that a CPP supplementary statement become a requirement, and comments were invited during a six-month period. Whilst the public accounting firms, on balance, favoured the CPP approach, it was opposed by most of the preparers who submitted comments (Tweedie and Whittington, 1984, pages 64–73).

In July 1973, six days before the end of the comment period, the Government 'shook the accounting profession' (ibid., page 74) by announcing in Parliament that it would be setting up an independent committee of enquiry on the adjustment of

[13]For examples of 'you manage what you measure', see Lowenstein (1996).

company accounts for inflation, citing 'the wide range of national interests affected by the subject' (ibid., page 74). This action precluded the ASSC from converting its exposure draft into an obligatory standard. Yet in May 1974 the Councils of the six accountancy bodies that sponsored the ASSC approved Provisional Statement of Standard Accounting Practice (PSSAP) 7, which embodied the recommendations in ED8. The provisional character of the standard meant that it was not binding on companies or auditors, but instead encouraged them to use the CPP approach to account for the effects of inflation. The government's committee of enquiry had been appointed in January 1974, and the ASSC and the accountancy bodies believed that the issue of an interim, non-binding standard was desirable.

There is evidence that 'the Government had been lobbied by a number of companies which opposed the introduction of a CPP standard' (ibid., page 76; Rutherford, 2007, Chapter 4). Moreover, government was concerned that a CPP approach might institutionalize inflation, and it feared that CPP accounting might be advocated as the basis for company taxation (Tweedie and Whittington, 1984, pages 76–7). Government thus saw the ASSC's initiative as a source of potential problems in other key areas.

In the end, the committee of enquiry, known as the Sandilands Committee, issued a report (HMSO, 1975) in September 1975 in which it backed current cost accounting (largely based on replacement costs) and rejected CPP accounting. PSSAP 7 therefore lost any practical effect it might have had.

Deferred taxes (1975–8)

Politics again intruded in 1976, after the governing Councils of the accountancy bodies sponsoring the ASSC (see Chapter 14) had approved Statement of Standard Accounting Practice (SSAP) 11 on accounting for deferred taxes. The standard would have required companies to record a liability for all timing differences between taxable income and accounting earnings. But the 1970s were an inflationary decade, and Parliament enacted two major income tax concessions: it authorized a 100 per cent first-year capital (i.e. depreciation) allowance on many fixed assets as well as stock appreciation relief for merchandise inventories, a variation of LIFO for tax purposes only. Because of these generous tax concessions at a time of considerable inflation, which would give rise to major timing differences, companies knew that they would be required to recognize very large deferred tax liabilities (see Chapter 9). Industry protested against the new standard vigorously, chiefly because of its adverse effects on company balance sheets.

In addition, a minister in the Labour government had been advocating a gradual nationalization of industry, and some companies feared that the government might call in the notional tax liability – which industry believed would grow and grow, and never reverse – as a down payment towards an eventual government takeover. For its part, government did not like the standard because it would oblige each company to record a much larger notional tax expense than was actually due, thus masking the significant tax concessions that government had given to enterprise. None of these were accounting arguments. They were self-interested pleading. In the end, the standard-setter was forced by these political pressures to withdraw the standard and replace it with one that allowed companies to record a much lower deferred tax liability, which could be expected to reverse in the foreseeable future (Hope and Briggs, 1982; Zeff, 1988, pages 21–2; Arnold and Webb, 1989, pages 29–30; Zeff, 2002, pages 46–8).

Research and development (1977)

A special pleading was also pressed on the standard-setter during the run-up to SSAP 13, issued in 1977. The aerospace industry used the following argument to persuade the standard-setter not to require the immediate write-off of development costs in SSAP 13:

> deferral should be permitted because the profit percentage allowed in government contracts was calculated on capital employed, which was defined as including development expenditure included in the balance sheet. Immediate write-off therefore would have reduced the profit calculation. In other words, the aerospace industry was worried about the possible economic effects of an accounting standard.
>
> Taylor and Turley (1986, page 84).[14]

The final standard did not require an immediate write-off of development costs.

Goodwill (1987–90)

In the last three years of the ASC's life,[15] it gamely attempted to impose some discipline on the accounting treatment of goodwill. SSAP 22, which had been issued in 1984, allowed almost unconstrained choice, and most companies continued to write-off goodwill against shareholders' equity.

In ED 47, issued in February 1990, just months before it was to give way to the ASB, the ASC proposed a single method: amortization to be charged to expense over a maximum of 20 years. This proposal was met by intense lobbying. Industry strongly opposed a requirement of amortization, and the stream of adverse letters of comment included protests from the Confederation of British Industry and the 100 Group of Finance Directors. A member of the ASC and of its working party on ED 47 has reported that members of the ASC and the working party were subjected to political pressure from colleagues and clients (Nobes (1992, page 154 and fn. 9)).[16] All of the Big-6 audit firms expressed opposition, one explanation being the need to avoid antagonizing actual and potential clients. Owing to the intense controversy, the ASC had no choice but to pass the goodwill project on to its successor, without resolution.

10.4 US political lobbying from 1990

10.4.1 Marketable securities (1990–3)

The SEC has historically been averse to companies carrying assets in their accounts at market value – its decision in 1978 to support reserve recognition accounting in the petroleum industry being the only prominent exception before 1990. However, in the early 1990s, its chairman argued that marketable securities should be 'marked to market'. The FASB responded with alacrity to this suggestion and began working on a draft standard that would value equity securities at market prices, with the unrealized

[14] For a fuller treatment of this controversy, see Hope and Gray (1982).
[15] In 1976, 'Steering' was dropped from the committee's name.
[16] Also see the interview with Nobes in Rutherford (2007, page 269).

holding gains and losses taken to earnings. The banking industry, abetted by its regulators, quickly reacted by mounting a campaign to oppose any such standard, as banks typically held large portfolios of securities. The industry was worried that bank earnings would become unmanageably volatile and therefore indicative, in the eyes of many observers, of instability in the banking system. No less a political figure than the Secretary of the Treasury wrote a letter to the FASB in which he asserted:

> This proposal could have serious, unintended effects on the availability of credit as well as on the stability of the financial system, and I strongly urge the FASB not to adopt it at this time . . . [Market value accounting] could even result in more intense and frequent credit crunches, since a temporary dip in asset prices would result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity.[17]

Under this assault from the banking industry, the FASB felt the need to craft a compromise. Equity securities would be classified as either 'trading' or 'available for sale'. Both would be marked to market, but only the unrealized holding gains and losses on the trading securities, which were to be sold in the near term, would be taken to earnings. Gains and losses accumulated on available-for-sale securities, usually the larger of the two portfolios, would be diverted to the shareholders' equity section, and would not affect earnings until the securities were actually sold. SFAS 115, issued in 1993, embodied this compromise, and the lion's share of unrealized gains and losses on equity securities were therefore diverted from earnings. Debt securities to be held until maturity were, as before, recorded at amortized historical cost (Kirk, 1991; Wyatt, 1991; Worthy, 1992; Scott, 2003, pages 460–4; Schultz and Hollister, 2003). Chapter 9 took this topic further.

10.4.2 Employee stock options (1992–5)

The best known of the recent political controversies dealt with employee stock (or share) options. On this subject, emotions were sky high, because the compensation packages of top executives were in peril. In 1993, the FASB published an exposure draft that called for the mandatory expensing of employee stock options in the income statement, using an estimate of fair value based on an option-pricing model. Previously, companies recorded no expense at all when granting stock options, because, in order to secure favourable income tax treatment, their exercise price was set equal to the market price of the shares on the date of the grant, so they had no 'intrinsic value'. Top executives, especially of high-tech enterprise, were livid with the FASB. In the high-tech field, many of the small companies granted options to all of their employees, not just to favoured top executives. Companies sensed that their earnings would take a hard hit and that shareholders would be less willing to tolerate generous grants of stock options if they were accompanied by a significant drop in company earnings.

As soon as the high-tech sector concluded that the FASB was unresponsive to their criticisms and objections, they appealed to members of Congress. Bills were introduced to order the SEC not to enforce an FASB standard that required expensing of stock options. At the same time, a number of other members of Congress, supporting

[17] Letter from Nicholas F. Brady to Dennis R. Beresford, FASB Chairman, dated 24 March 1992.

the FASB position, tabled bills that ordered the SEC to enforce any such standard. In March 1994, the FASB held a public hearing in Silicon Valley, and a raucous 'STOP FASB' protest rally, complete with inspirational speakers and a high school marching band, drummed up a frenzy of opposition. The rally was widely covered in the local media. Six weeks later, US senators recruited by the opponents of the FASB's proposal approved a non-binding resolution by a lop-sided vote of 88–9 to urge the FASB not to adopt the standard, as it 'will have grave economic consequences particularly for business in new-growth sectors which rely heavily on employee entrepreneurship . . . [and] will diminish rather than expand broad-based employee stock option plans'.[18]

Warren Buffett, the widely respected American investor and member of corporate boards of directors, defended the FASB and said:

> If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?[19]

The lines were drawn, and the stakes were high. Then, in October 1994, the same senator who had sponsored the resolution that had sailed through the Senate introduced another bill, which, if passed, would require the members of the SEC to affirm by a majority vote any new FASB standard before it could go into effect. Such legislation would threaten the future viability of the FASB. Shortly afterwards, the SEC Chairman privately counselled the FASB to retreat from its position because of the intense heat on Capitol Hill. The chairman, who had previously spoken out in support of the FASB's exposure draft, has since written:

> I warned [the FASB] that, if they adopted the new standard, the SEC would not enforce it . . . In retrospect, I was wrong. I know the FASB would have stuck to its guns had I not pushed it to surrender. Out of a misguided belief that I was acting in the FASB's best interests, I failed to support this courageous and beleaguered organization in its time of need, and may have opened the door to more meddling by powerful corporations and Congress.
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> Levitt and Dwyer (2002, page 110)

In the end, the FASB, by a vote of 5–2, approved SFAS 123 which favoured expensing the fair value of stock options in the income statement, but few companies adopted this treatment. The allowed alternative was a footnote disclosure of the impact that any stock options expense would have on earnings. For fuller discussions of this affair, see Zeff (1997), Mozes (1998), Miller *et al.* (1998, pages 137–42) and Revsine *et al.* (2005, pages 876–81).

It had been a wrenching affair, which the FASB had no desire to repeat. Yet, as will be seen in Section 10.7, it had to be repeated between 2002 and 2004, when the FASB carried out its commitment to converge with IFRS 2, Share-based payment.

10.4.3 Business combinations and goodwill (1996–2001)

For some years, the SEC's accounting staff had wanted the FASB to tackle 'pooling of interests' versus 'purchase' accounting for business combinations (see

[18] *Congressional Record – Senate*, 3 May 1994, page S 5032.
[19] *Congressional Record – Senate*, 3 May 1994, page S 5040.

Chapters 8 and 16). The staff complained that 40 per cent of their time was consumed with issues relating to business combinations. The issue was finally added to the FASB's agenda in 1996. After a lengthy process of enquiry, the board resolved in a 1999 exposure draft to eliminate pooling of interests as an acceptable accounting method and to reduce the maximum useful life for amortizing goodwill and other intangibles from 40 to 20 years, which would have harmonized with IAS 22 (as revised in 1993). Whilst industry was resigned to the elimination of pooling of interests, it did not like the prospect of having to reduce earnings each year by an automatic 5 per cent charge for goodwill amortization, especially when it was believed that the amount of goodwill in many recent acquisitions had become a sizeable percentage of the acquisition price. Industry appealed to Congress to help dissuade the FASB from its position on goodwill amortization.

The FASB's positions in its exposure draft precipitated hearings, in March and May 2000, on Capitol Hill, in the Senate and the House of Representatives. A former FASB Chairman has made the following observation on Congressional hearings called to address proposed FASB standards:[20]

> The FASB often is on the defensive because these hearings are generally convened when certain companies, industry associations, or others allege that pending FASB positions will cause serious economic harm if adopted as final accounting standards. Although parties sympathetic to the FASB are sometimes invited to speak, the deck is often stacked in favor of the opponents.

The two hearings on business combinations and goodwill were of that ilk, but the FASB stood its ground. Even so, two members of the House of Representatives introduced a bill that would delay the implementation of the FASB's proposed standard, and 13 Senators expressed their concern over the standard in a letter to the FASB.[21] A senior senator, the chairman of the powerful Committee on Banking, Housing, and Urban Affairs, held a 'Roundtable Discussion on Accounting for Goodwill' in June 2000, before the FASB's exposure draft could be converted into a standard. During the session, he directed the following remarks to the FASB's chairman:

> In a financial snapshot at the point of an acquisition, I would argue that purchase accounting is superior to pooling of interest. The problem comes, however, in that purchase accounting requires that this goodwill be written down over time, even though, in any successful merger, we expect the value of that goodwill to rise and not to decline.
>
> The question then becomes, are the problems created by arbitrarily writing down goodwill sufficient to override the benefits in approximating reality that we get from purchase accounting? Is there a way you can develop an approximation that would allow you to assess periodically the value of goodwill and whether or not it's being preserved, whether or not it's declining, whether or not it's actually rising in value?[22]

The chairman had expressed a very similar view in March 2000 during the hearing held by his Committee.[23]

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[20]Beresford (2001, page 74). This is the best single work on the business combinations and goodwill controversy from 1996 up to 2000. Also see Zeff (2002, pages 50–1) and Ramanna (2008).

[21]'FASB Under Fire from Politicians', *World Accounting Report* (November 2000), page 2.

[22]'Gramm's Statement at Roundtable Discussion of Accounting for Goodwill', News from the Senate Banking Committee (14 June 2000).

[23]'Prepared Statement of Chairman Phil Gramm', *Pooling Accounting*, hearing before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 106th Congress, 2nd Session (2 March 2000), page 47.

After the FASB Chairman returned to his offices, the board proceeded to reconsider its proposed treatment of goodwill. By December, the board had concluded that, in principle, it could support a periodic impairment test for goodwill.[24] It therefore decided to issue a revised exposure draft to replace the requirement that goodwill be amortized over a period of up to 20 years by a requirement that goodwill be reviewed periodically for impairment. The final standard, SFAS 142, included the periodic impairment test for goodwill.

10.4.4 Derivatives at fair value (1997–8)

With SFAS 133, the FASB introduced the requirement to measure derivative securities at fair value. In the run-up to the issue of the standard, its opponents, including the American Bankers Association, used their leverage to engage members of Congress. Bills intended to frustrate the FASB were introduced both in the Senate and the House, and public hearings were held (Beresford 1998; Zeff, 2002, page 51).[25] However, in the end the FASB succeeded in issuing the standard in June 1998.

10.4.5 Banks' accounting for losses under fair value accounting (2008–9)

In October 2008, in the throes of the financial crisis, pressure on the FASB had begun to build, as financial services firms as well as banks feared the impact on their regulatory capital if their holdings of mortgage-backed securities and collateralized debt obligations had to be accounted for at fair value in a market characterized by distressed prices. In that month, the US Congress hurriedly approved an act which authorized the SEC to suspend the use of fair value accounting. Two months later, an SEC study concluded that the existing fair value rules should not be suspended, and in January 2009 the FASB reiterated its support for fair value accounting. Then, in March 2009, 15 Congressmen sponsored a bill designed to establish a Federal Accounting Oversight Board, whose members would include the chairman of the Federal Reserve Board, the Secretary of the Treasury, the chairman of the Federal Deposit Insurance Corporation, as well as the SEC Chairman and the chairman of the Public Company Accounting Oversight Board, which would 'approve and oversee accounting principles and standards for purposes of the Federal financial regulatory agencies and reporting requirements required by such agencies'. The aim was clearly to curtail the required use of fair value for financial instruments (Revsine *et al*., 2015, pages 398–400).[26]

On 12 March 2009, at a hearing of a subcommittee of the House Committee on Financial Services, Chairman Paul Kanjorski, a Democrat from Pennsylvania, verbally assaulted FASB Chairman Robert Herz because of the alleged negative effects his

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[24]See 'Business Combinations – FASB Reaches Tentative Decisions on Accounting for Goodwill', *FASB Status Report*, No. 331 (29 December 2000), page 1, and 'A Landmark Proposal from FASB', *The Accountant* (December 2000), page 3. The board would have been aware that the UK Accounting Standards Board stated in FRS 10, issued in December 1997, that any goodwill and other intangibles with an amortizable life in excess of 20 years or not being amortized must be subjected to an annual impairment review.

[25]For news reports, see 'Squaring off on derivatives', *Journal of Accountancy*, December 1997, and 'Damn the torpedoes – Full speed ahead on derivatives', *Journal of Accountancy*, July 1998.

[26]See H.R. 1349, Financial Accounting Oversight Board Act of 2009, issued in the House of Representatives on 5 March 2009, at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.1349.

board's standards on fair value accounting were having on banks in the economic crisis. Kanjorski threatened the FASB Chairman that, if the FASB did not take definitive action within the next three weeks to cushion these effects, legislation would be advanced to achieve the same aim.[27] This pressure was comparable to that exerted by the European Commission on the IASB during the previous October (see Section 10.5.5, below), yet it involved different aspects of the accounting by banks for financial instruments. It was reasonable to believe that the US banking community and bank regulators had pressed their views on the House subcommittee.

Three weeks to the day following the hearing, the FASB issued two Staff Positions that potentially had the effect of reducing the magnitude of losses taken by banks for 'other than temporary impairments' on available-for-sale securities and gave banks greater flexibility to determine fair values for illiquid assets, albeit with expanded disclosures. The former decision was taken by a 3–2 vote. These concessions made by the FASB, which allowed very little time for its normal due process, were promptly criticized in the financial media.[28] In the end, the threatened Federal Accounting Oversight Board was not established.

10.5 Political lobbying of the IASC/IASB

10.5.1 Elimination of LIFO (1992)

Even before the IASC's standards became requirements in several countries, a display of special-interest lobbying afflicted the board. This occurred in 1992, when the IASC board attempted to carry out one of the provisions in its *Statement of Intent*, issued in 1990, that LIFO should be eliminated as an acceptable treatment.[29] Because LIFO could be used for income tax purposes in Germany, Italy, Japan and South Korea, countries in which tax reporting and financial reporting were intertwined, the delegations to the IASC board from those countries voted against the elimination of LIFO. One supposes that the delegations aligned themselves with views expressed within their countries that nothing should be done to disturb the tax benefits conferred by LIFO. These four negative votes constituted a blocking minority, and the motion to eliminate LIFO failed. The defeat of the motion, which was unexpected, became an embarrassment to the IASC board. Interestingly, the US delegation to the board voted in favour of eliminating LIFO, despite the common use of LIFO in the US (see Chapter 8), believing that it was not a proper accounting method.

Finally, in 2003 the IASB, as part of its Improvements project, eliminated LIFO in its revision of IAS 2.

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[27]For a report on this issue, see Susan Pulliam and Tom McGinty, 'Congress helped banks defang key rule', *The Wall Street Journal*, (3 June 2009), pp. A1, A14. For an extract from the hearing, see Howieson (2011, pages 5–6). See *Mark-to-Market Accounting* (2009) for the full hearing. For an editorial view, see 'Messenger, shot', *The Economist* (US edition), 11 April 2009, page 18

[28]See Floyd Norris, 'Banks get new leeway in valuing their assets', *The New York Times* (2 April 2009), Jack Ciesielski, 'FASB's FSP decisions: bigger than basketball?', *The AAO Weblog* (2 April 2009) and Jennifer Hughes, 'Regulator says non-US banks will miss out after accounts rule shift', *Financial Times* (3 April 2009), page 13.

[29]*Comparability of Financial Statements*, Statement of Intent, International Accounting Standards Committee, July 1990, p. 19.

10.5.2 Share-based payment (2001)

When the IASB began work in 2001, one of the topics on its agenda was share-based payment, which included employee stock options. Prior to developing an exposure draft, the board re-exposed the G4+1 (see Chapter 4) research report on the subject (Crook, 2000). The report recommended that share options be expensed in each period in which employee services were performed, based on the fair values of the options at the end of each successive reporting period. This re-exposure precipitated a letter-writing campaign from 15 major European multinationals. The letter writers complained that a standard embodying this recommendation would place them at a competitive disadvantage compared with companies using US GAAP, which did not need to record such an expense in their accounts and thus depress their earnings. These were the companies that wrote the letters:

Nokia (Finland)
Ericsson (Sweden)
Bayer (Germany)
DaimlerChrysler (Germany)
Océ (Netherlands)
Philips (Netherlands)
ING (Netherlands)
UBS (Switzerland)
Nestlé (Switzerland)
F. Hoffmann-La Roche (Switzerland)
Saint-Gobain (France)
Lafarge (France)
Pirelli (Italy)
Repsol YPF (Spain)

Key passages in several of the letters were identical, suggesting that at least some of the letters were written in concert, probably organized by the European Round Table of Industrialists, a lobbying organization of major multinationals. Their argument took advantage of one of the recitals in the proposed IAS Regulation, which was then under consideration by the European Parliament (see Chapter 5), as follows:

> (15) In its deliberations on and in elaborating positions to be taken on documents and papers issued by the IASB in the process of developing international accounting standards (IFRS and SIC-IFRIC), the [European] Commission should take into account the importance of avoiding *competitive disadvantages* for European companies operating in the global marketplace, and, to the maximum possible extent, the views expressed by the delegations in the Accounting Regulatory Committee. The Commission will be represented in constituent bodies of the IASB.
>
> [emphasis added]

Despite this intervention before the IASB had even composed an exposure draft, the board succeeded in issuing IFRS 2 in February 2004, which requires that companies expense the fair value of employee stock options. At the exposure draft stage, companies had softened their opposition, perhaps because of the concern over accounting abuses arising from the widely publicized Enron and WorldCom scandals. A year later, in February 2005, the European Commission formally endorsed IFRS 2 for use in Europe. In December 2004, the FASB had issued SFAS 123(R), which converged, in large measure, with IFRS 2, but the political opposition in Congress to prevent the US standard from going into effect led to the introduction of blocking legislation (see Section 10.7).

10.5.3 Financial instruments (2002–4)

IAS 39 (revised 2003), which addresses the measurement and recognition of financial instruments, became the major political battle of the young IASB's life. The initial version of IAS 39 had been issued by the IASC in December 1998, being the last of its standards to form part of the 'core set', which the International Organization of Securities Commissions (IOSCO) endorsed in May 2000. It had been difficult enough for the IASC to agree on the standard, even though there were then comparatively few countries in the world where its standards really mattered in terms of national GAAP. The proposal by the European Commission to require all listed companies in the European Union (EU) to use international standards in their consolidated statements by 2005 was not announced until June 2000, and the relevant Regulation formally imposing this requirement was adopted by the Council of the EU in June 2002.

In 2001, the Commission encouraged the European private sector to set up a body to screen IFRSs for technical soundness. The body that shortly came into being was the European Financial Reporting Advisory Group (EFRAG). It proceeded to authorize the creation of a Technical Expert Group (TEG) composed of accounting experts from EU countries. The TEG sends comments to the IASB on its draft standards, and it advises the Commission on the technical propriety of IFRSs. To enable the Commission to receive advice at the 'political' level, the Regulation created an ARC consisting of government representatives from the EU's member states. The TEG's advice is also to be sent to the ARC. The final decision to endorse IFRSs for use in Europe, and thus make them subject to the Regulation, is taken by the Commission, although the European Parliament can delay the decision.

The revised IAS 39 was the first serious test of this new relationship between the IASB and both EFRAG and the Commission. It was also the first standard that so infuriated an important preparer sector in Europe that it brought unrelenting pressure on the Commission to qualify its endorsement. The objections to the standard, which the IASB tried but failed fully to accommodate,[30] were twofold: its full fair value option as applied to certain liabilities, and the restriction on hedge accounting that prevented the banks from hedging their portfolio of core deposits. The loudest complaint, especially coming from the French banks, was that the standard would afflict them with unacceptable earnings volatility and that it would require them to change their risk management practices to their disadvantage. The European Central Bank argued that the full fair value option would lead to an undervaluation of bank liabilities, especially if discounted at a high interest rate, reflecting the bank's weak credit standing. Moreover, the Commission asserted that the standard's full fair value option is contrary to an article in the EU's Fourth Directive on company accounts. This argument was of dubious merit, if only because the Commission itself could initiate a procedure to modify the Directive accordingly.

The objections from France reached fever pitch in July 2003, when President Jacques Chirac wrote to Commission President, Romano Prodi, that the IASB's proposed standard on financial instruments would have '[disastrous] consequences for

[30]In March 2004, the IASB issued an amendment to IAS 39, Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk, which failed to placate the opponents of the standard.

financial stability'.[31] The European Central Bank and the Basel Committee on Banking Supervision also were concerned about aspects of the standard that could create artificial volatility.

For its part, the TEG recommended endorsement of IAS 39, but by a curious vote of 5 in favour and 6 against. The rules of the TEG provide that it may recommend rejection of a proposed endorsement only when at least two-thirds of its members oppose a standard. The ARC recommended endorsement of IAS 39 in October 2004, but 'minus the provisions on full fair value and portfolio hedging on core deposits'.[32] These became the two 'carve-outs' of the Commission's partial endorsement of IAS 39 announced in November.[33] In June 2005, responding to criticism, the IASB issued an amendment to IAS 39 on the fair value option, which led the Commission to eliminate the 'carve-out' on that subject. The 'carve-out' on hedge accounting for core deposits remained.

Among the dilemmas facing the IASB was that, if it were to accommodate completely all of the objections emanating from Europe, it would, in its view, have issued a standard that was less than principled. It was essential to the IASB that the door be open for convergence with the FASB. But the FASB Chairman made it known that his board could not converge with other than a high-quality standard.[34] Furthermore, the 'carve-out' is believed to be a source of concern to the SEC's accounting staff,[35] who have been encouraging the FASB and the IASB to eliminate the differences in their respective standards at a high level of quality. The SEC and the IASB hoped that, one day, the requirement that the SEC imposed on foreign registrants to reconcile their IFRS-based earnings and shareholders' equity to US GAAP could be dropped, but only if the convergence between US GAAP and IFRS was, in the SEC's eyes, at a high level of quality (see Chapter 5).

Questions are now being raised about whether standard-setters or regulators in other parts of the world would use the precedent set by the Commission to accommodate domestic opposition to future IFRSs, by carving out objectionable passages. Although the Commission denies that its 'carve-outs' of IAS 39 constitute a precedent, it could nonetheless take similar action on a future IFRS.[36]

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[31]Quoted in 'IAS Unstoppable', *Global Risk Regulator Newsletter* (July/August 2003), http://www.globalriskregulator.com/archive/JulyAugust2003–19.html. In news articles containing this quotation, the English rendering of the French *néfaste* has been nefarious, but 'disastrous' is a better translation.

[32]'EU Accounting Regulatory Opinion on IAS 39' (19 November 2004), IP/04/1385, http://www.iasplus.com/europe/0410arcopinion.pdf.

[33]'Accounting Standards: Commission Endorses IAS 39', press release, http://www.iasplus.com.europe/0411ecias39pr.pdf.

[34]See, for example, 'US watchdog warns Europe: European opposition to derivatives rules may hinder agreement on global accounting', *Financial Times*, 25 August 2003.

[35]In a speech on 8 March 2007, SEC Commissioner Roel Campos complained that the SEC had received only 40 sets of foreign companies' financial statements for the year 2005, which were said to be prepared in accordance with IFRS. The SEC had expected to receive some 300 such reports. Among the other 260 would have been those of EU companies whose auditors are required to state that their financial statements have been fairly presented in accordance with IFRS as adopted by the European Union. Even if, for companies other than banks, the carve-out does not apply, the auditor and company nonetheless do not in many cases affirm that the financial statements comply with IFRS as issued by the IASB. See http://www.sec.gov/news/speech/2007/spch030807rcc.htm.

[36]'IAS 39 Financial Instruments: Recognition and Measurement – Frequently Asked Questions (FAQ)' (19 November 2004), MEMO/04/265, http://www.iasplus.com/europe/0411ecias39faq.pdf.

10.5.4 Operating segments (2006–7)

In 2006, the IASB issued a new standard, IFRS 8, to replace IAS 14 on segment reporting. IFRS 8 is similar to the US standard on operating segment disclosures, and convergence was one of the IASB's objectives.

Positive endorsement advice was given by EFRAG, and the European Commission was in favour of endorsement. However, a campaign to oppose endorsement led to a request by a committee of the European Parliament for the European Commission to conduct an impact analysis of the standard. Finally, in November 2007, one year after the IASB issued the standard, the Parliament finally assented to its endorsement. More details are given in Chapter 18.

10.5.5 Reclassification of investments in securities (2008)

A genuine crisis arose in October 2008, resulting from the sharp drop in the stock markets during an early stage of the world financial crisis. A number of important French financial institutions, which had large holdings of debt securities classified as 'trading', desperately wanted to avoid having to report huge losses on their holdings in their quarterly report dated 30 September, which was about to be issued. With support from powerful forces in the French Government, they urged the European Commission to pressure the IASB to approve a rule that would allow them, with immediate effect, to re-classify their holdings as 'held to maturity' *backdated* (to when the prices of the securities were higher than their carrying amounts on their books) in order to avoid having to report the losses in the quarter just ended. During the week of 6–12 October, the Commission threatened the IASB with the loss of its franchise to set standards in the EU unless it were to approve such a rule in the next few days. The pressure on the board was immense, as if a pistol were being held to its head. At short notice, the IASB secured the IASC Foundation trustees' authority to override its normal due process, and on Monday 13 October, with two dissenting votes, the board, with great reservations, approved an amendment to IAS 39 to enable the reclassification, with the backdating to 1 July 2008. At the same time, IFRS 7 (on financial instrument disclosures) was amended. The European Commission endorsed the amendments a scant two days later, this becoming the fastest endorsement on record.

Whilst such a re-classification had been available under US GAAP, the IASB had not previously allowed it. But the manner in which political pressure was put on the IASB to make this change, without the normal exposure process, was unprecedented, and it led to a chorus of criticism, especially in the United States, over the inability of the IASB to withstand such self-interested lobbying. In the end, apparently only a small number of financial institutions availed themselves of the re-classification with backdating. Again, it was the French who protested, and again the protest dealt with accounting for financial instruments.[37]

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[37]For news reports on this episode, see: 'Fair value rules may be eased to head off EU threat', *Financial Times*, 13 October 2008, page 20; 'Fair value accounting rules eased', *Financial Times*, 14 October 2008, page 18; 'EU regulators back emergency change to bank accounting rules', *Financial Times*, 16 October 2008, page 15; and 'Meltdown at the IASB?', *World Accounting Report*, November 2008, pages 2–3. For criticism of the lack of due process leading up to the Board's decision, see 'National standard-setters protest', *World Accounting Report*, December 2008/January 2009, page 4.

10.6 Preparer attempts to control the accounting standard-setter

10.6.1 The United States

It was not enough for preparers to confront the FASB on particular accounting issues. Beginning in 1985, they took a number of steps to try to 'rein in' the FASB. In 1985, the FEI urged that a second preparer be appointed to the seven-person FASB, which was done, displacing the lone former financial analyst on the board. In 1988, the Business Roundtable, composed of the chief executive officers of some 200 of the largest US publicly traded companies and banks, pressed the SEC to cooperate in setting up a board to oversee the FASB. The board would exercise control over the FASB's agenda and could reject any standards after the FASB had approved them. The SEC Chairman peremptorily rejected the proposal, saying that the SEC oversees the FASB. Then, in 1990, probably with the encouragement of the preparer lobby, the trustees of the Financial Accounting Foundation (FAF), who appoint FASB members and raise funds, changed the FASB's minimum voting rule for approving standards from 4–3 to 5–2, ostensibly to slow the board's pace.[38]

A major confrontation erupted in 1996. Shortly after the FASB approved SFAS 123 on employee stock options in the wake of the political assault from Congress (see Section 10.4), the FEI President apprised the Chairman of the FAF trustees of the FEI's strong desire to take steps to bring the FASB more under preparer dominance. That led to a move by the SEC Chairman to protect the independence of the FAF board of Trustees. He insisted that the FAF board appoint four trustees who represent the public interest. Until then, all of the trustees were appointed by the FAF's sponsoring organizations, which included the FEI. Initially, the FAF board resisted, until the SEC Chairman threatened a loss of SEC support for the FASB unless it were to comply. In the end, the FAF appointed four new trustees who were well known to the SEC Chairman, increasing the size of the FAF board from 14 to 16.

This series of interventions – and there were others not mentioned above – indicates how seriously the preparer community in the United States takes the FASB as an unwelcome force in its financial affairs. For a full account of the initiatives taken by the preparer community between 1985 and 1996, see Van Riper (1994, Chapter 8) and Miller *et al.* (1998, pages 179–93).

10.6.2 The IASB

One of the consequences of the IAS 39 affair (see Section 10.5.3) was a move by the European preparer sector to press EFRAG to expand its role and mission so as to take expressly into account the self-interested concerns of European industry towards future IFRSs. EFRAG was therefore to venture beyond its purely accounting domain and to enter the realm of political and economic impact. An EFRAG policy statement issued in April 2004 said that, in accordance with this broadened authority, 'EFRAG, when expressing views on major issues will need to analyze their economic, legal and practical implications with the input of other stakeholders . . . Some of these issues

[38]In 2000, the trustees quietly voted to restore the 4–3 simple majority.

may give rise to political debate.' Proposed IFRSs are to be 'fully discussed in the context of the "European Public Good" at an early stage'.[39] Political impact is therefore to be given a higher profile in EFRAG's deliberations. In this way, European industry could appeal to EFRAG as well as to the Commission on 'political' grounds.

From 2003, the IASC Foundation trustees, who oversee the IASB, conducted a review of its Constitution and working procedures. European industry and the Commission had been urging the IASB to improve its consultation procedures, meaning, to exhibit a greater willingness to accept the views of critics in the preparer community. European industry and the Commission wanted to see more representatives from adopter countries on the board of trustees as well as on the IASB, and fewer from the United States, which does not use IFRSs. They succeeded in persuading the trustees to broaden the criterion of 'technical expertise' for membership on the IASB to 'professional competence and practical experience', so that the board might become less of an 'ivory tower'. The trustees also made a change in the required minimum vote for approval of standards from a simple majority of the 14 members to 9–5. The Commission and EFRAG had argued for 10–4 and wanted the board to have more than two part-time board members.[40] To some, these reforms (effective from 1 July 2005) may be reminiscent of attempts made by preparer bodies in the United States to gain greater control over the FASB. But the standard-setter must be regarded as a fair and open-minded arbiter by those who are affected by its decisions.

Three years later, following criticism by two committees of the European Parliament, the IASC Foundation trustees proposed creation of a Monitoring Group composed of international public sector authorities to oversee the performance of the trustees, including their process of appointing new trustees in the event of vacancies. The Parliament's committees contended that a private-sector body, such as the IASB, could not make EU law – that is, impose its standards on EU companies – unless it were made accountable to public sector agencies of international standing. A Monitoring Board, whose name reflects a weightier role than 'Group', came into existence on 1 February 2009, and its initial membership included leading figures from the European Commission, the US SEC, Japan's Financial Services Agency, and IOSCO.[41]

The trustees began gradually increasing the board membership from 14 to 16, with the possibility of including up to three part-time members, but then they let the board size decrease to 14. All of the members are currently full-time. In principle, the board is now to be composed geographically as follows: four members from Europe, four from North America, four from Asia/Oceania, one each from Africa and South America, and two from any area, with a view towards achieving an overall geographical balance. Under these new criteria for membership, it is possible for the Board to have solely full-time members, which flies in the face of the argument of some critics that full-time members risk losing touch with the 'real world' in which accounting is practised.

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[39]'The Enhancement of the Role and Working Process of EFRAG' (28 January 2004), http://www.iasplus.com/efrag/0404enhancement.pdf.

[40]The full report by the trustees on their proposals for changes in the Constitution may be downloaded from the IASB website. A summary of these major proposed changes may be found in the entry for 23 November 2004 on the IASPLUS.com website. For a recent expression of the further constitutional changes being urged by the EC, see the letter from Alexander Schaub, Director-General of Internal Market and Services, to Tom Seidenstein, Director, International Accounting Standards Foundation, dated 7 March 2005. Letters of comment received by the Foundation in response to an Invitation to Comment issued in 2003 are posted on the IASB website.

[41]The trustees' press release can be found at http://www.iasplus.com/pressrel/0901monitoringboard.pdf.

10.7 Political lobbying of the FASB's convergence with the IASB

10.7.1 Employee stock options: round 2 (2002–5)

In 2002, there were two developments in the United States on accounting for employee stock options. In the wake of the Enron and WorldCom bankruptcies and alleged frauds, pressure began to build on companies to take steps to restore public and shareholder trust. The failure of companies to expense the fair value of stock options was seized upon as an example of corporate abuse. As noted above, this treatment to record an expense was the one favoured by the FASB in its SFAS 123, issued in 1995; however, all but a few companies initially opted instead to disclose the dilutive effect on earnings of the expense in a footnote. Because of the efforts of Warren Buffett, several major companies – including Coca-Cola, the *Washington Post* and General Electric – announced in 2002 that they would in future record stock option expense in their income statements. The movement to adopt this treatment began to resonate with the media and with shareholders, and pressure began to build on other companies to follow their lead. The momentum proceeded apace, and by the end of 2004, more than 825 companies had made such an announcement, of which about 120 had common stock so widely held that they were included in Standard & Poor's 500 index. But this was still a small fraction of the some 14,000 companies reporting to the SEC.

The other development in 2002 was the FASB's issue of an *Invitation to Comment*, comparing its SFAS 123, as modified, with the IASB's recently issued exposure draft on share-based payment (see Section 10.5). This initiative carried forward FASB's commitment to converge with IFRSs. The FASB knew full well that it was again headed into the path of a political storm over accounting for employee stock options. In March 2004, the FASB issued an exposure draft, calling for the required expensing of the fair value of stock options in the income statement, which was similar in many respects to its exposure draft issued in 1993 (see Section 10.4). A record number of comment letters, exceeding 14,000, was received.[42]

Propelled mostly by the high-tech sector, members of Congress quickly lined up behind a legislative proposal, known as the Stock Option Accounting Reform Act (HR 3574), designed to severely limit the applicability of any FASB standard based on the exposure draft. Under the bill, the mandatory expensing of the fair value of stock options would apply only to a company's chief executive officer and the four other most highly compensated executives. This represented a major concession to the many high-tech companies that granted stock options to most of their employees. The bill also stipulated, contrary to financial wisdom, that volatility shall be zero when an option-pricing model is used to estimate the fair value of options. The House of Representatives passed the bill by a vote of 312 to 111, which was indicative of the breadth of support across party lines. However, several key senators pronounced themselves opposed to interference with the FASB. By the time the 108th Congress adjourned in December 2004, a companion bill (S. 1890) was still

[42] *Share-Based Payment*, Statement of Financial Accounting Standards No. 123 (revised 2004) (FASB, December 2004), para. C23. This standard is referred to in this chapter as SFAS 123(R).

pending in the Senate. For a study of four Congressional hearings in 2003–4, see Young (2014).

Despite this Congressional action, the FASB unanimously approved SFAS 123(R) in December 2004, but its effective date was postponed until 15 June 2005 because the SEC believed that companies were already overwhelmed at the year end with implementing internal controls mandated by the Sarbanes-Oxley Act of 2002. In April 2005, the SEC extended the effective date, for most companies, by another six months.

In February 2005, a new blocking bill, the Broad-Based Stock Option Plan Transparency Act (HR 913), was introduced in the House by the same people who had supported HR 3574 in the previous Congress.[43] It would require the SEC to improve the stock option disclosures in footnotes to the financial statements, including their dilutive effect on earnings per share. At the end of three years, the SEC would be required to transmit to Congress its report on the effectiveness of these enhanced disclosures. Before the end of the three-year period, the SEC would not be allowed to recognize SFAS 123(R) as part of GAAP. The aim of the bill was transparent: to be the first stage in an effort to prevent the FASB's standard from ever taking effect.

Because of the unyielding opposition by two key senators, the momentum behind the House bill petered out, and the FASB's standard went into effect for 2006. Nonetheless, initiatives such as those taken in the House, obviously driven by company lobbying, could well occur on other topics, such as leasing. Political lobbying truly represents a potential threat to the achievement of genuine international convergence of accounting standards.

10.7.2 IASB/FASB lease proposal for lessees (2010–2)

In May 2012, two members of the US House of Representatives, both of whom are CPAs, organized a letter-writing campaign, together with 58 other members of the House, which protested against the IASB's and FASB's joint proposal of August 2010 that lessees should capitalize the assets and liabilities for all leases longer than 12 months, with only a few exceptions. In their letter, the 60 House members cited a controversial study by a consulting firm known as Chang & Adams which claimed that such capitalization would have significantly deleterious effects on the national economy.[44] The letter was sent to the FASB Chairman with copies of the SEC Chairman and the IASB Chairman, and it was reported in the press.[45] This Congressional initiative seemed not to have any impact on the two boards, because they issued a revised exposure draft in May 2013 which again called for lease capitalization by lessees.

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[43]Complete information about the transaction of business in the Congress may be found at http://thomas.loc.gov.

[44]See 'Congressman Sherman and Congressman Campbell lead effort to stop new accounting rules for leases', at: http://bradsherman.house.gov/2012/05/congressman-sherman-and-congressman-campbell-lead-effort-to-stop-new-accounting-rules-for-leases.shtml.

[45]See, e.g., Dena Aubin, 'FASB under political heat from Congress over lease accounting', Reuters (US), 29 May 2012, at: http://blogs.reuters.com/taxbreak/2012/05/29/fasb-under-political-heat-from-congress-over-lease-accounting/, and Michael Cohn, 'Congressmen urge FASB to reconsider lease accounting changes', *Accounting Today*, 22 May 2012, at: http://www.accountingtoday.com/news/Congressmen-Urge-FASB-Reconsider-Lease-Accounting-Changes-62744-1.html.

10.8 Some concluding remarks

Before the 1990s, the US Securities and Exchange Commission was the only securities market regulator that rigorously enforced compliance with GAAP. Since the 1990s and especially in the 2000s, other countries have fortified their enforcement agencies. But the level and consistency of their performance in Europe and elsewhere is still highly variable, partly because of their insufficient budgets and weak supporting legislation. Furthermore, regulatory cultures are different in different countries. However, once the standard-setter is of high quality and the regulator is also of high quality, not only will the standards potentially improve the quality of company reporting, but the increased incidence of insistent political lobbying from the preparer community could lead to diluted or compromised standards. At the least, they are likely to lead to more detailed standards, with extra paragraphs specifying provisos, exemptions, exceptions and clarifications in order to accommodate special interests pressed upon the standard-setter.

Can one deny that political lobbying is a reality of standard-setting both at the national and international levels? As the stakes get higher, the political opposition to disagreeable change will surely grow in intensity. To a considerable degree, the preparers of financial reports have become a countervailing power against a standard-setter that is seen to overstep its authority. An intelligent student of the standard-setting process must be attentive to the phenomenon of political lobbying.

SUMMARY

- Political lobbying is the bringing of pressure on standard-setters, typically by companies or governments, beyond a debate about the technical merit or compliance costs of a particular proposed standard.
- The motivations of the lobbyist can include a desire to make earnings look larger, smaller or less volatile. In the case of governments, lobbying can concern the desire to ensure that various economic incentives have more attractive accounting results.
- Lobbying of the US standard-setters up to 1990 included that on replacement cost depreciation, the investment tax credit, business combinations, petroleum exploration costs, marketable securities, leases, segment reporting, restructuring of debt and post-employment benefits.
- UK examples include those on inflation accounting (when the government was involved), deferred tax, research and development and goodwill.
- US lobbying from 1990 concerned marketable securities, stock options and goodwill; two of which were repeats of earlier cases.
- As the IASC/B became more important, so it was more lobbied. Examples concern LIFO, share-based payment and financial instruments.
- There were also preparer attempts to control the FASB and, later, the IASB.
- Share-based payment returned as a major topic for US lobbying when the FASB sought to converge with the IASB.

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Useful websites

Accounting Standards Council	www.frc.org.uk
European Commission	www.europa.eu.int
European Financial Reporting Advisory Group	www.efrag.org
Financial Accounting Standards Board	www.fasb.org
Financial Executives International	www.financialexecutives.org
International Accounting Standards Board	www.ifrs.org
Securities and Exchange Commission	www.sec.gov

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

10.1* Explain the various motivations of those who politically lobby standard-setters.

10.2* Give examples of political lobbying of US standard-setters, explaining in what ways the lobbying went beyond arguments about the correct technical solutions.

10.3 Why might it be expected that there would be more examples of political lobbying relating to the US than to any other country?

10.4 Give examples of political lobbying of the IASC/B, explaining why and how lobbying has increased over the years.

10.5 Discuss the view that political lobbying could and should be reduced by giving preparers more say in the setting of accounting standards.

10.6 Is there a connection between the amount of political lobbying in a country and the degree of independence of the standard-setter from (a) government departments, and (b) the accountancy profession?

10.7 Discuss the role of a conceptual framework as a defence against political lobbying.

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Part III

CHINA AND JAPAN

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11 Financial reporting in China and Japan

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OBJECTIVES

After reading this chapter, you should be able to:

- explain the key similarities and differences between China and Japan in the factors affecting financial reporting;
- outline the major foreign influences that have affected accounting requirements in Japan and the resulting unusual features of its system;
- explain the various layers of governmental requirements in Japan and the difference between Commercial Code statements and Securities Law statements;
- illustrate the main differences between Japanese practices and those used under IFRS or US GAAP;
- comment on the degree of international harmonization achieved and expected in Japan;
- summarize the development of accounting in China from the late 1980s;
- explain how China has fused old and new ideas in accounting;
- outline the main features of the accounting rules for Chinese listed companies;
- discuss the remaining differences between Chinese practices and IFRS.

11.1 Introduction

The previous chapters dealt with reporting by listed groups in most of the world's largest economies, which use IFRS or US GAAP. However, there are two major exceptions to the use of IFRS or US GAAP, and this chapter looks at accounting in the two largest economies of the East: China and Japan. China has become the world's second largest economy and may eventually be the largest. Japan used to be second and is now third.

Despite many unique features of China and Japan, there are some similarities in their institutional contexts. First, both have very long traditions of central imperial control. Secondly, and appropriate to this, both countries have commercial legal systems that are derived from nineteenth-century European codes. That is, accounting in these countries has a Roman law context, which fits with central imperial control. Thirdly, accounting has been heavily influenced from outside.

In Japan, the strong outside influence began more than a century ago, first from Europe and then from the United States. In the new millennium, the IASB has become a key factor in the development of Japanese accounting. These issues are discussed in Section 11.2. Then, Section 11.3 examines accounting practices under Japanese GAAP. Section 11.4 looks at the differences between Japanese GAAP and IFRS.

China has substituted one European-invented economic system (communism) for another (stock-market-based capitalism). This has brought dramatic changes in the purposes and operations of accounting, but features of the former system are still clearly visible. Again, the IASB has been of great importance, especially since China adopted new standards for listed companies that are closely based on IFRS. This is discussed in Section 11.5. The differences between IFRS and Chinese GAAP for listed

companies are examined in Section 11.6, as is the practice of those Chinese companies which present IFRS financial statements.

The coverage of Japan in this chapter is more extensive than that of China, and comes first, for three reasons. Firstly, the importance of Japanese listed companies is still larger than that of Chinese ones. Secondly, Japan's accounting system has developed continuously from the late nineteenth century, although with a major change from the late 1940s, whereas China's present system is largely a product of the 1990s onwards. However, China's accounting will no doubt grow in international importance. Thirdly, for listed companies, Chinese accounting standards are now very close to IFRS, so there are fewer differences to discuss.

11.2 Japan: regulatory issues

11.2.1 Context of accounting

This section examines the development of Japanese accounting since the introduction of Commercial Codes in the late nineteenth century. We particularly comment on the changes over the last decade, as an illustration of harmonization in accounting. In this sub-section we look at the context of accounting. Later sub-sections examine the regulatory framework, then accounting practices and differences from IFRS.

The industrialization of Japan began in earnest in 1868 after the Meiji Restoration. The government was responsible for encouraging and enabling the growth of industry. At least until the Second World War, the Japanese economy was controlled by a small number of *Zaibatsu*, industrial–political consortia usually involving a bank and originally based on noble families. The importance of banks and the existence of several closed aspects of business control still continue, although informal groupings called *Keiretsu* have replaced *Zaibatsu*.

After the Second World War, Japan developed into one of the world's economic superpowers. By the end of 1989, the market capitalization of the Tokyo Stock Exchange was greater than that in New York, though it then fell dramatically. The Nikkei index went from a peak of 38,916 at the end of 1989 to well below a third of that in 2005. At the end of 1994, the market capitalization in Tokyo was still over three times the size of London's (*The Economist*, 1996, page 56), although by 2007 they were much nearer, and by 2015 nearly the same (see Table 1.5). For 1994/5, the common feature of the world's six largest banks was that they were all Japanese (*The Economist*, 1996, page 54); however, by the end of 1998, none of the top six were Japanese (*Financial Times*, 1999), due partly to the fall in the yen and partly to the fall in the Japanese stock market. Table 1.10 shows that there are now only a small number of Japanese companies amongst the world's largest. The massive fall in share prices and asset prices during the 1990s led to the need for bank reorganizations and rescues. It also led to an increased openness to change and outside influence in accounting. In the 2000s, the Japanese economy slowly recovered and the yen rose, but in 2008 Japan experienced sharper falls in the stock market than did the United States or the United Kingdom.

The state has had the most significant influence on accounting in Japan (Arai and Shiratori, 1991). However, this comes from three separate sources: the Companies Act (formerly the Commercial Code, deriving from continental European influence); the Financial Instruments and Exchange Act (deriving from US influence); and tax law. These are examined in Section 11.2.3 below. There is little overall coordination of these sources and they sometimes have conflicting approaches to financial reporting issues. Leuz (2010) puts Japan with France and Germany in his clusters of regulatory variables, as reproduced in Table 3.2 in Chapter 3.

Listed companies in Japan are subject to the requirements of the Financial Instruments and Exchange Law. The Tokyo Stock Exchange also has its own listing requirements. Although the stock exchanges are now very large (see Table 1.5), Japanese companies have normally relied heavily on debt rather than equity as their principal source of finance, and banks have been the main providers of this (Cooke and Kikuya, 1992, page 46). In many cases, banks own a significant proportion of a client's shares, and may even be the largest shareholder. In general, shares in Japanese companies are held on a long-term basis. The heavy involvement of the banks and the long-term nature of share ownership means that there is less focus on short-term earnings information in Japan than in the United Kingdom or the United States. The banks have direct access to their clients' accounting information, and so have relatively little interest in external financial reporting. Also, there are often reciprocal shareholding arrangements between companies. These shareholders, as well as banks, may tend to have private accounting information and to vote with the company's management at annual meetings.

The Japanese accounting profession has had relatively little influence on financial reporting, because of the importance of the above governmental sources of authority. The Japanese Institute of Certified Public Accountants (JICPA) was a founder member of the IASC, but the latter had little effect on Japanese financial reporting until the 1990s. The primary reason for this is that the IASC originally sought to implement its standards through the efforts of the national professional accounting bodies, but JICPA had limited influence. More obvious long-term international influences on Japanese financial reporting are that of Germany on the original Commercial Code and that of the US on the Securities Law. The US influence narrowed the scope for the IASC/B. Nevertheless, from 1993 to 1995 there was a Japanese chairman of the IASC and this coincided with increased international influence in Japan.

In 2001, a private-sector standard-setter was established partly in order to liaise with the new International Accounting Standards Board. As explained in Section 11.2.4 below, a project of converging Japanese standards with IFRS was formally begun in 2005. In 2009, it was announced that IFRS would be allowed for the consolidated statements of certain listed companies for years ending on 31 March 2010 onwards. A number of companies have taken this up (see 11.2.6). A proposal that this might be followed by compulsory adoption in 2015 or 2016 was abandoned when the United States abandoned its similar proposal in 2012 (see Section 5.6).

Rather confusingly, in addition to convergence of Japanese GAAP with IFRS and permission to use IFRS, there is now a third approach: Japanese modifications of IFRS. The first two modified standards were issued in June 2015. The first requires amortization instead of impairment for goodwill. The second requires any gains and losses recorded in other comprehensive income to be eventually reclassified to profit

or loss. These are issues on which Japan disagrees with the IASB, and hopes to persuade the IASB to change. Japanese companies are allowed to use modified IFRS for year ends of March 2016 onwards.

11.2.2 Forms of business organization

The most common form of business organization in Japan is the *kabushiki kaisha*. This is similar in many respects to the public limited company in the United Kingdom, although an even closer analogy is the German *Aktiengesellshaft* (AG), which was the model for the *kabushiki kaisha* (see Chapter 14). There are approximately one million *kabushiki kaisha* in Japan. They must have a minimum issued capital of ¥10 million. Only about 3,400 of these have their stock traded publicly (see Table 1.5). Consequently, although all companies whose shares are publicly traded are *kabushiki kaisha*, by far the majority of *kabushiki kaisha* have few shareholders and are relatively small.

The next most common form of business organization in Japan was the *yugen kaisha*. The nearest equivalent in the United Kingdom would be the private limited company, although the German GmbH is closer. The shareholders of a *yugen kaisha* have limited liability in the same way as the shareholders of a KK. The main differences between a *yugen kaisha* and a *kabushiki kaisha* are restrictions on shareholders. A *yugen kaisha* cannot have more than 50 shareholders, whereas there is no upper limit on the number of shareholders of a *kabushiki kaisha*. A shareholder in a *kabushiki kaisha* may dispose of the shares only if the other shareholders give their consent. There is no such restriction for a shareholder in a *kabushiki kaisha*, although the articles of incorporation may require that shares be disposed of only with the approval of the directors. However, the Companies Act of 2005 does not allow any new *yugen kaisha* companies to be set up. Instead, a new type of private company (a *godo kaisha*) was invented.

There are two main types of partnership in Japan: a *gomei kaisha* is a general or unlimited partnership; a *goshi kaisha* is a combined limited and unlimited partnership, consisting of one or more limited partners and one or more unlimited partners.

11.2.3 Regulatory framework

The first source of regulation is the Companies Act of 2005 that included the requirements of the former Commercial Code. This is administered by the Ministry of Justice and applies to all *kabushiki kaisha*. It has its roots in the German Commercial Code of the nineteenth century, which was first adapted by the Japanese in 1890. However, the German influence has diminished over time as amendments have been made.

In general, the staff in the Ministry of Justice have a legal background rather than an accounting background. Consequently, the administration of the law is influenced, as in Germany, by the belief that the protection of creditors is at least as important as the protection of shareholders. This may explain why the specific accounting rules of the law place greater emphasis on prudent asset valuation than on income measurement. Independent professional audit is required for companies with share capital over ¥500 million or total liabilities over ¥20 billion.

The second source of regulation is the Financial Instruments and Exchange Act of 2006, formerly the 'Securities Law', which applies only to those *kabushiki kaisha*

that are publicly traded. The Securities Law was first enacted shortly after the Second World War, when General MacArthur was responsible for the Allied administration of Japan (Chiba, 2001). The MacArthur regime took the US system of accounting regulation as the model for the revised Japanese system. The main US influences on the Japanese Securities Law were the Securities Act of 1933 and the Securities and Exchange Act of 1934. This Securities Law was administered by the Ministry of Finance until 2000 and now by the Financial Services Agency (FSA). Consequently, the functions and powers of these arms of government in relation to financial reporting are similar in many respects to those of the US Securities and Exchange Commission. An SEC was established by the US occupying administration in 1947 but dismantled when the Americans left in 1952.

The accounting measurement requirements and particularly the disclosure and filing requirements of Japan's Securities Law are more extensive and specific than those of the Companies Act (see Cooke, 1993a, for a comparison). A company must file its financial statements with the FSA and with any stock exchange on which it is listed. The financial statements (see Section 11.2.5) are available for public inspection at the Ministry and at the relevant exchanges. All companies subject to the Securities Law must be audited.

The FSA is in charge of a reference document known as *Business Accounting Principles*, which was first issued in 1949, based on a US model (Kikuya, 2001). The document has been amended many times. All companies that report under the Securities Law must comply with these *Principles*. The financial reporting requirements of the FSA tend to place greater emphasis on income measurement and shareholder protection than on asset valuation and creditor protection, in contrast to the Code of the Ministry of Justice referred to above.

The FSA had an advisory body, originally called the Business Accounting Deliberation Council (BADC), whose members came from a variety of backgrounds, such as industry, the accountancy profession, government and the universities. Until the formation of the Accounting Standards Board in 2001 (see below), the BADC also published 'opinions' and 'standards' on particular issues. The BADC has been replaced by the Business Accounting Council (BAC), which is still concerned with auditing guidelines.

A kabushiki kaisha that is publicly traded is subject to both the sources of government influence described above. Consequently, it must prepare two sets of financial statements: one for the shareholders (not for the public), in accordance with the requirements of the Companies Act; and one for filing, in accordance with the requirements of the Securities Law. Net income will be the same in the two sets of financial statements. The principal difference is the greater amount of disclosure required under the Securities Law. Another significant difference is that there is no requirement in the Companies Act to prepare consolidated financial statements. The Act requires KK companies to publish a condensed version of their financial statements in newspapers or an official gazette. Companies below the size criteria mentioned earlier need only publish a condensed balance sheet.

The third source of regulation arises from the tax laws and rules. These have a significant impact on financial reporting, because, as in many continental European countries, certain deductions for expenses and deferrals of income are only permitted for tax purposes if they are reflected in the company's statutory accounts as prepared

under the Companies Act. Examples of these deductions and deferrals are depreciation, allowances for bad debts, accrued employee severance indemnities and profit from instalment sales. The general point is that the Companies Act, Securities Law and *Business Accounting Principles* are all rather vague in some areas, so tax law is often looked to for detailed rules. For example, the Companies Act requires current assets to be valued at cost unless there is a 'substantially lower' market value. This tends to lead to use of the tax rule's meaning of a decline of 50 per cent or more (Sawa, 2003, page 179).

Companies often choose an accounting practice that maximizes the tax benefit, rather than one that more accurately reflects the underlying economic reality. Another influence that the tax laws have is that some non-deductible items, such as directors' bonuses, are charged by companies against retained earnings rather than against income.

So there are three distinct government influences on financial reporting. The influence of the FSA has increased relative to that of the Ministry of Justice. Because of the fundamental difference in the attitude of the two authorities, this change in relative influence has resulted in a move away from a 'legal' approach to a more 'economic' approach to financial reporting requirements.

11.2.4 The private sector: the accountancy profession and accounting standards

The Japanese accounting profession has had relatively little influence on financial reporting compared to the Anglo-Saxon professions (Sakagami *et al.*, 1999). The JICPA was established during the US administration by the Certified Public Accountants Law of 1948 (although there was a predecessor body established by a law of 1927). The JICPA has approximately 26,000 members. It is thus of comparatively recent origin and is small compared to the Anglo-Saxon professional bodies.

Until 2001 (see below), the JICPA issued recommendations on relatively minor accounting matters. A company that reports to the FSA under the Securities Law had to comply with the pronouncements because non-compliance would be considered a departure from acceptable accounting practice. If the departure were material, the FSA would require the company to amend its financial statements.

Very few members of the JICPA hold senior financial positions in industry or commerce. Consequently, the Japanese accounting profession has little influence on the preparers of financial information. This is in contrast to the United Kingdom, for example, where most of the financial directors of large companies are members of the accounting profession. As in Germany, there is a separate (and larger) profession of tax experts in Japan. As mentioned earlier, the BADC included representatives of the accounting profession. So these individual members of the JICPA could influence financial reporting by influencing the form and content of the *Business Accounting Principles*. The BAC's Auditing Committee still includes auditors.

In 2001, a private-sector standard-setting authority (the Financial Accounting Standards Foundation) was set up, partly so that there would be a body to liaise with the new IASB. The Foundation was established by ten private-sector organizations, including the JICPA. The objective was to transfer rule-making in accounting from the public sector (e.g. the BADC) to the private sector. Along the lines of the

arrangements for standard-setting in the US, the UK and the IASB, the Japanese organization has a supervisory Board of Governors and an Accounting Standards Board of Japan (ASBJ). In 2015, the board had 13 members (four full-time).

One of the main tasks of the board is to assist in the convergence of Japanese practice towards international practice. As part of this process, the IASB and the ASBJ announced a project designed to remove the major differences in the rules (IASB, 2005). The ASBJ issued a 'Statement on Japan's Progress towards Convergence' in 2006. It revealed that a number of issues were outstanding, though most of those were under review. The Tokyo Agreement of August 2007 proposed that major differences would be removed by new standards issued by 2008, and other differences by 2011.

By early 2015, the ASBJ had issued 26 'Statements', which are shown in Table 11.1. Some of these (e.g. No. 8 on share-based payments, No. 11 on related party disclosures and No. 25 on other comprehensive income) are largely in line with IFRS. Others deal with specifically Japanese issues (e.g. No. 6 on the statement of changes in net assets). The Japanese differences from IFRS are examined in Section 11.4.

11.2.5 Contents of annual reports

Companies Act requirements

The specific regulations that govern the form and content of the financial statements required under the Act are contained in the 'Regulations Concerning the Balance Sheet, Income Statement, Business Report and Supporting Schedules of Joint Stock Corporations'. The Ministry of Justice first issued these in 1963 and has subsequently amended them from time to time, including a major revision in 1982.

The financial statements prepared under the Companies Act must include a balance sheet, an income statement and a statement of changes in net assets. These are unconsolidated statements. In terms of the formats discussed in Chapter 2, the Japanese balance sheet is two-sided, starting with liquid assets; and the income statement is vertical, by function. A company must also present various supplementary schedules to the shareholders' meeting, including details of changes to share capital and reserves, acquisitions and disposals of fixed assets, and transactions with directors and shareholders.

For large companies, whose financial statements are audited and filed with the FSA (see Section 11.2.3), consolidated statements are also required.

Securities Law requirements

The specific regulations that govern the form and content of the financial statements required under the Financial Instruments and Exchange Act (Securities Law) are contained in the 'Regulations Concerning the Terminology, Forms and Preparation Methods of Financial Statements', first issued by the Ministry of Finance in 1963. The financial statements prepared under the Securities Law must include a balance sheet, an income statement, a statement of changes in net assets, a statement of cash flows, certain supplementary schedules and certain additional unaudited information. The supplementary schedules include details of share capital and reserves, long-term

Table 11.1 Standards of the ASB Japan (mid-2015)

Statement	
1	Treasury shares and appropriation of legal reserves
2	Earnings per share
3	Amendment to standard on retirement benefits
4	Directors' bonuses
5	Presentation of net assets
6	Statement of changes in net assets
7	Business divestitures
8	Share-based payments
9	Measurement of inventories
10	Financial instruments
11	Related party disclosures
12	Quarterly financial reporting
13	Lease transactions
14	Amendment to standard on retirement benefits
15	Construction contracts
16	Revised standard for equity method of accounting for investments
17	Disclosures about segments of an enterprise and related information
18	Asset retirement obligations
19	Partial amendments to standard on retirement benefits
20	Disclosures about fair value of investment and rental property
21	Business combinations
22	Consolidated financial statements
23	Partial amendments to standard on research and development costs
24	Accounting changes and error corrections
25	Presentation of comprehensive income
26	Retirement benefits

Source: Prepared by the author.

debt, fixed assets and intra-group transactions. The additional unaudited information includes details of the company's organizational structure, employees, production and cash flows.

Items such as profit and loss for the year and shareholders' equity will be the same in the financial statements that a company prepares under the Securities Law as in those prepared under the Companies Act. However, the regulations of the former are the more detailed on terminology, form and content of the financial statements, and will normally require a company to disclose additional details of certain items, or to reclassify certain items disclosed in the Companies Act financial statements. The legal requirements are summarized in JICPA (2010).

Japanese companies that are listed on US exchanges are allowed to file US GAAP consolidated reports in Japan. It had been decided in 2009 that permission to use US GAAP would be revoked, as part of adopting IFRS, but this decision was reversed in 2011, and a few dozen Japanese companies still use US GAAP. As explained in 11.2.6, some companies are now *allowed* to use IFRS, and use is increasing.

Convenience translations

A foreign user of Japanese financial statements generally faces one immediate and important difficulty: the language barrier. It is obvious that, with Japanese financial statements, there are not only different *words* from English but also a different *script*. Consequently, few Western users can even guess at the key elements of a set of Japanese statements. The language barrier may be overcome in several different ways. A Western firm of stockbrokers may employ Japanese nationals to translate and comment on Japanese financial statements, and individual shareholders may benefit from this; or a user interested in the financial statements of a particular Japanese company may employ a firm or individual who specializes in translating Japanese material.

Some large Japanese multinational companies prepare English-language versions of their annual reports. For example, a Japanese company that is listed on the New York Stock Exchange must comply with the relevant requirements of the SEC. These require either a set of English-language financial statements in accordance with US GAAP or IFRS, or a reconciliation from Japanese to US GAAP. Although US GAAP financial statements may be helpful to a user, they are not of course a reliable source of information about financial reporting in Japan. Japanese companies are one of the largest groups of foreign SEC registrants (Godwin *et al.*, 1998), particularly of those that provide US GAAP statements rather than reconciling to US GAAP.

Some Japanese companies that are not listed on a foreign stock exchange still prepare English-language financial statements. These are sometimes described as 'convenience translations'. A company may prepare a convenience translation as part of a public relations and marketing exercise. It usually includes the relevant amounts in yen, and translates the yen amounts into US dollars using the appropriate year-end exchange rate. The report normally emphasizes that the company has translated the yen amounts into dollars solely for the convenience of the reader, which does not imply that they actually have been, or could be, translated into dollars. A convenience translation normally uses income measurement principles and asset valuation principles that are in accordance with Japanese GAAP. However, a convenience translation may include additional disclosures that are not required by Japanese GAAP, and may reclassify some financial statement items into a form that is more familiar to non-Japanese readers (Nobes and Maeda, 1990). Such reclassifications normally do not affect the values of total assets, of shareholders' funds or of the profit for the year. Convenience translations provide a useful insight into some aspects of financial reporting in Japan. However, the additional disclosures and the reclassifications referred to above mean that they also do not provide an accurate picture of financial reporting in Japan.

11.2.6 Voluntary adoption of IFRS

As mentioned in Section 11.2.5, certain Japanese companies have been allowed, from 2010, to use IFRS for their consolidated reporting. The original conditions set out by the BAC in 2009 were:

- the company is listed in Japan;
- the company has staff skilled in IFRS;
- the company must be subject to foreign securities regulation or have a large foreign subsidiary (capital of at least ¥2 billion).

The scope was expanded in 2010 to include the consolidated statements of a Japanese subsidiary whose parent meets the above criteria. In 2013, the first and last conditions above were removed, leaving only the rather vague second condition (see: http://www.fsa.go.jp/en/news/2013/20130621-1/01.pdf). As in the EU and Australia, there is a formal process of scrutinizing IFRS: the standards have to be 'designated' by the FSA, but there have been no cases of non-designation so far.

Companies were fairly slow to take up the permission to use IFRS. Nihon Dempa Kogyo did so for the year ended 31 March 2010, then Hoya and Sumitomo for 2011, then Nippon Sheet Glass, Japan Tobacco, Anritsu and Chugai Pharmaceutical for 2012. After that, many companies have adopted IFRS. The FSA published a survey in 2015 (accessible at: http://www.fsa.go.jp/en/news/2015/20150430-4/01.pdf). This shows that, by March 2015, 75 companies had adopted IFRS or had announced adoptions, amounting to over 18 per cent of Japanese market capitalization. The FSA suggested that the main reasons for IFRS adoption by a company were (i) to simplify accounting in a group with many foreign subsidiaries, and (ii) to improve international comparability.

11.2.7 Audit

Independent professional audit is required for listed companies and for other companies meeting one of these two criteria:

- either the company has share capital over ¥500 million, or
- its total liabilities amount to more than ¥20 billion.

The relative weakness of the Japanese accounting profession (see Section 11.2.4) is emphasized again by the fact that the BAC, not the JICPA, controls auditing standards. However, from 1991, the BAC (or its predecessor) has recognized JICPA as the body that can prepare and issue implementation guidance on these standards. The FSA requires that the audit of financial statements for Securities Law purposes must be conducted in accordance with generally recognized auditing practices, which shall be taken as meaning the auditing standards and working rules issued by the BAC.

Yoshimi (2002) explained how auditing was gradually being taken more seriously in Japan. Then, in 2003 and in 2007 major changes were made to the Certified Public Accountants Act to increase the independence of auditors. These were influenced by the Sarbanes-Oxley Act of 2002 in the United States. Details on all the above can be found in JICPA (2013).

11.3 Japan: accounting practices

11.3.1 Assets

Tangible assets and depreciation

The balance sheet of a Japanese company must show non-current assets at cost (less aggregate depreciation). Borrowing costs on self-constructed assets are generally not capitalized, whereas they must be under IFRS or US GAAP. The regulations do not

allow revaluation with the exception of land (see below). This conservative approach is in line with German and US practice, but in contrast to permission to revalue in several IASB standards. However, in 1998 a new law (amended in 1999) allowed large companies (see Section 11.2.3) to revalue land up to March 2001. Any resulting revaluation reserve is not taxed as a gain and therefore gives rise to a deferred tax liability.

The most common depreciation method in Japan is reducing-balance (Cooke and Kikuya, 1992, page 223). Companies generally use the depreciation rates that are prescribed in the tax laws, and the same applies to residual values for depreciation calculations. Impairment tests compare the carrying values of assets with their undiscounted cash flows, as in US GAAP (see an example in Section 8.6.1). This means that there are fewer impairments than under IFRS, where this test does not exist, and where impairments are generally measured by comparing carrying values with discounted cash flows.

The capitalization of leases was once rare in Japan, as would be expected for a country that concentrates on the tax rules and the legal form rather than commercial substance. However, in 1993 the BADC issued a guideline requiring 'ownership transfer' leases to be capitalized and other finance leases either to be capitalized or to be disclosed by provision of substantially the same information. However, this changed to approximately the position under IFRS or US GAAP (i.e. the capitalization of finance leases) as a result of the publication of ASBJ Statement No. 13 in 2007. There are numerical criteria to determine whether a lease is a finance lease, as in US GAAP (see Section 8.6).

Intangible assets

The BADC required R&D to be expensed from April 2000 onwards. This is like US GAAP, under which companies are not permitted to defer most development costs. By contrast, under IFRS, capitalization of development costs is compulsory when certain criteria are met. Previous surveys of Japanese financial reporting (Gray *et al.*, 1984; Cooke and Kikuya, 1992, page 224) found that 80 per cent of the companies wrote off development cost immediately, as incurred. Other intangibles such as preliminary expenses and costs of issue of securities may be capitalized in Japan, but not under IFRS or in the United States.

Unlike IFRS or US GAAP, there is no concept of 'indefinite-life' intangibles which must not be amortized but annually checked for impairment. In Japan, all intangibles are amortized, often using tax-based rates. Non-consolidation purchased goodwill (*Noren*) is capitalizable, and then amortized over five years on a straight-line basis. This is tax deductible (Nobes and Norton, 1996).

Investments

Until 2000/1, financial assets were generally valued at cost or at a lower value after a major loss. Consequently, gains could be postponed for years until sale, and most falls in value were ignored. However, from 31 March 2001 balance sheets onwards, marketable financial assets are treated approximately as under US GAAP or IFRS. That is, in summary:

- in an investor's unconsolidated statements, investments in subsidiaries, joint ventures and associates are held at cost;

- bonds held to maturity are valued at amortized cost;
- marketable trading securities are valued at fair value with gains and losses going to income (whether realized or not);
- other investments are valued at fair value with gains and losses going to equity. However, investments in unlisted securities are measured at cost.

Inventories

ASBJ Statement No. 9 (of 2006) requires the use of the lower of cost and market, where market generally means net realizable value (NRV). Under IAS 2, the lower of cost and NRV must be used. In the United States, companies use replacement cost where it is lower than cost and NRV. The ASBJ Statement allows companies to retain the lower value even when the market subsequently rises (as in the US) or to use the lower of cost and *current* NRV (as in IFRS).

Where a company cannot specifically identify the actual cost of an item of inventory, the company was (until 2011) allowed to choose from a variety of flow assumptions: weighted average cost, FIFO, or (under some circumstances) LIFO. In practice, as in Germany, weighted average cost has been more common than either FIFO or LIFO. Naturally, as in the United States in this case, the method chosen for accounting must be the same as the method chosen for taxation. The IASB banned LIFO for 2005 onwards, and it is not allowed in Japan for March 2011 year ends onwards.

Receivables

Companies sometimes calculate the allowance for doubtful debts in accordance with what the tax laws permit. Consequently, it may be more than the amount that a comparable company elsewhere would include (JICPA, 1994, page 13). A Japanese company is permitted to record an allowance in excess of that allowed for tax purposes, but the excess would not be tax deductible and so few Japanese companies do this. This is an illustration of how the tax laws influence financial reporting in Japan.

The Japanese treatment of foreign currency receivables and payables was until 2000 different from that in most other countries. As is common under German GAAP, short-term items (maturing within one year) were translated at the closing rate, but long-term items were translated at the historical rate of the transaction (except when a material loss has occurred). However, Japan has adopted the US/IFRS treatment of using closing rates for both short-term and long-term items.

11.3.2 Equity and liabilities

Legal reserve

The Companies Act requires a company to transfer an amount equal to at least 10 per cent of its dividends paid to a legal reserve, until the reserve equals 25 per cent of the capital stock account. This is similar to, but larger than, French or German legal reserves. The legal reserve is undistributable, but may be capitalized following the appropriate legal procedures, e.g. to issue bonus shares. The requirement for a legal reserve illustrates the creditor-protection orientation of the Companies Act. The reserve is designed to ensure that the company does not adopt a profligate dividend policy at the expense of its creditors.

Deferred taxation

As already mentioned, tax laws have a significant influence on financial reporting in Japan. Material timing differences rarely arise, because the amounts in the financial statements normally correspond closely to the amounts in the tax accounts. For example, companies normally charge in their financial statements the same amount of depreciation as for tax purposes, i.e. the maximum amount permitted for tax purposes. Because material timing differences are rare, the practice of deferred tax accounting did not develop in Japan.

The Companies Act does not refer specifically to deferred taxation, but its accounting rules limit the deferral of expenses to certain specified categories, not including income taxes. Consequently, the Act seems to prohibit a company from recording a deferred tax asset, although not a deferred tax liability. However, it is inconsistent for some companies to record a deferred tax liability when other companies are prohibited from recording a deferred tax asset. So deferred tax accounting was rarely found in (unconsolidated) financial statements prepared under the law (JICPA, 1994, page 35).

Traditionally, deferred tax was also rarely accounted for in consolidated financial statements. However, BADC pronouncements have required full allocation of deferred tax in all financial statements for March 2000 year ends onwards. The JICPA issued an audit guideline on the recognition of deferred tax assets.

Gee and Mano (2006) review the convergence of the Japanese rules on deferred tax with US and IASB standards. They show that deferred tax assets were very important in the balance sheets of Japanese banks in 2002 to 2004.

Pensions

Traditionally, almost all Japanese companies had (unfunded) employee retirement and termination plans that required amounts to be paid when employees left a company, calculated using length of service, salary and other factors. However, increasingly, major companies are establishing Western-style funded, external pension plans.

The amounts charged as expenses in Japan were often limited to those allowed by tax law, which is 40 per cent of the payments that would be required if all employees voluntarily terminated at the year end. However, BADC pronouncements required full provision for employee benefits in consolidated statements for accounting years ending in March 2001 onwards. Even fairly minor differences from IFRS have been addressed. For example, ASBJ Statement No. 19 of 2008 requires a discount rate measured at the year end (as in IAS 19) rather than in the period leading up to it. However, Statement No. 26 of 2012 retains the US approach to the treatment of actuarial gains and losses. That is, the balance sheet shows the full liability (from 2013), but the actuarial gains/losses are initially taken partly to profit or loss and partly to other comprehensive income, though eventually they all end up in profit or loss.

Proposed dividends

Proposed dividends are recorded as current liabilities in Japan, whereas they are not recorded until approved by the shareholders meeting under IFRS or US GAAP.

11.3.3 Extraordinary items

In the income statement format, extraordinary items are separated out from others and shown in a separate section before corporate taxes. They include gains and losses on the sale of non-current assets, and material restatements resulting from corrections of errors. This is a much wider definition than in the United States (where such items seldom arose in practice, and are not allowed from 2016). The IASB banned the presentation of such items for 2005 onwards.

11.3.4 Consolidation and currency translation

Group financial reporting is a relatively recent development in Japan compared with its use in the United States. Financial reporting in Japan has traditionally emphasized parent company financial statements rather than consolidated financial statements. As has been mentioned, the Companies Act does not generally require consolidated financial statements; the Securities Law required them only as supplementary information until 1992. However, in another change to the Regulations in 1998, relating to listed KKs, consolidated statements became the prime basis for securities reporting.

One difference from European or IFRS rules used to be that a subsidiary was defined in Japan as an enterprise in which another owned more than half the voting shares, rather than the definition being based on the vaguer concept of 'control'. This changed in Japan for accounting years ending in March 2000 onwards (Seki, 2000). One major problem is that the informal *Keiretsu* groupings are not covered by the consolidation rules because there is no parent company.

The Regulations prescribe the normal specific procedures for preparing consolidated financial statements. For example, companies must eliminate intra-group balances and transactions, and must recognize minority interests in consolidated subsidiaries that are not wholly owned by the group. However, Japanese consolidations have, in some cases, been allowed to include numbers from foreign subsidiaries without imposing uniform policies. This is still allowed by ASBJ guidance of 2006 for certain aspects of accounting by subsidiaries under IFRS or US GAAP. For example, Japan Tobacco (see Section 11.4.2 below) states that it includes most subsidiaries on the basis of US GAAP.

There are considerable international differences in how groups eliminate goodwill from their balance sheets. In Japan, a group must amortize goodwill over its useful economic life. The amortization period normally follows that for non-consolidation goodwill, i.e. it does not exceed five years, and sometimes goodwill is amortized in just one year. However, international harmonization can be seen again in a Japanese move to allow up to 20 years from accounting years ending in March 2000 onwards. As noted in earlier chapters, the US and IASB have since moved to an impairment-only approach for goodwill, but Japan has not yet caught up with that change. Negative goodwill is treated as a liability and amortized into income in Japan, whereas it is treated as immediate income under IFRS and seldom arises under US GAAP.

Japanese groups must use the equity method to account for associated companies in group accounts, as in the United States or under IFRS. This is also the normal practice for joint ventures.

The Japanese accounting treatment of foreign subsidiaries on consolidation was considerably different from that in the United States or under IFRS. The requirements

are contained in a BADC statement known as the 'Accounting Standard for Foreign Currency Transactions', which was issued in 1979 and subsequently amended in 1984 and 1995. Until this last amendment (effective from 1996) the standard required a group to use a modified temporal method to translate the financial statements of foreign subsidiaries for consolidation purposes. Under this method, historical rates were used for assets held at historical costs and for capital and non-current liabilities, and the closing exchange rate was used for most assets and liabilities measured at current values, such as receivables, payables and inventories carried at market value (see Chapter 17). The amended standard requires the use of the closing rate for balance sheet items and the average rate for income statement items. This is similar to US or IFRS requirements.

11.4 Japan: differences from IFRS

In this section, we discuss the differences between Japanese GAAP and IFRS. Then, we look at case studies on the differences, using two different techniques. First, a review of a Japanese annual report reveals accounting policies which are different from IFRS. Secondly, when a Japanese company first adopts IFRS, it has to provide a numerical reconciliation from Japanese GAAP to IFRS.

11.4.1 An overview

In the last 20 years there have been major changes in Japan. As mentioned earlier, a private-sector standard-setting body was established in 2001. Even before this, the BADC had been adjusting Japanese requirements towards those of the IASC or the United States. By the accounting year end of 31 March 2001, many traditional Japanese accounting features had been abandoned, as explained in detail above. However, unlike the position in several European countries, there were no examples of Japanese companies directly using IFRS for their financial statements (Sawa, 2003, page 183) until this was specifically allowed by the FSA for 2010 statements onwards.

As explained earlier, a major convergence project has been in process, although largely this has meant changes to Japanese standards rather than to IFRS. Table 11.2 lists some of the major ways in which Japanese requirements would not allow, or would not require, conformity with IFRS for March 2015. In addition to these, the PwC comparison of IFRS and Japanese GAAP records a very large number of issues covered in IFRS but on which 'There are no specific requirements' in Japan (PwC, 2014).

11.4.2 A case study on IFRS/Japanese GAAP differences

In this sub-section, we review the annual report of Japan Tobacco Inc for 2010 (pages 85–87), in its convenience translation form (see Section 11.2.5). We use the 2010 report, because in 2011 the company was preparing to adopt IFRS. The quotations below all reveal differences from IFRS, and there have been no changes to Japanese

Table 11.2 Some major Japan/IFRS differences, 2015

	Topic	Japan	IFRS
1	PPE and investment property	Historical cost basis	Fair value allowed
2	Borrowing costs on construction	Generally expensed	Capitalized
3	Development costs	Expensed (except software)	Some must be capitalized
4	Pre-opening costs	Can be capitalized	Must be expensed
5	Intangible amortization	All amortized	Indefinite-life not amortized
6	Goodwill	Amortized up to 20 years	Annually impaired
7	Impairment test	Based on undiscounted cash flows	No test; measured using discounted cash flows
8	Impairment reversals	Not allowed	Required when appropriate
9	Inventory write-downs	Can be treated as permanent	Reversed when appropriate
10	Unlisted shares	At cost	At fair value
11	Provisions	Can be made when no obligation; generally not discounted	Only when obligation; discounted
12	Proposed dividends	Can be accrued	Not accrued
13	Convertible debentures	Generally treated as debt	Split into equity and debt
14	Extraordinary items	Wide definition	Not allowed
15	Discontinued operations	Not disclosed	Disclosed in detail
16	Temporarily-held subsidiaries	Excluded	Consolidated

GAAP since 2010 (at least until the time of writing, mid-2015) which would affect these differences. We have added comparisons with IFRS in square brackets.

> Inventories are stated at cost determined principally by the average cost method. ASBJ Statement No. 9, . . . requires that inventories . . . be measured at the lower of cost or net selling value . . . The replacement cost may be used in place of the net selling value, if appropriate. [Japanese rules, like US GAAP, sometimes involve using replacement cost when it is lower than historical cost or net realizable value.] In addition, leaf tobacco . . . was subject to annual devaluation prior to April 1, 2008. [The company no longer uses this sort of depreciation, because of the new standard, ASBJ Statement 9.]
>
> In March 2007, the ASBJ issued ASBJ Statement No. 13. . . . Under the previous accounting standard, finance leases that deem to transfer ownership of the leased property to the lessee are to be capitalized. However, other finance leases were permitted to be accounted for as operating lease transactions . . . The revised accounting standard requires that all finance lease transactions should be capitalized. [Finance leases are capitalized under IAS 17. The company did not do this until the 2009 statements.]
>
> An impairment loss would be recognized if the carrying amount of an asset or asset group exceeds the sum of the undiscounted future cash flows expected to result from the . . . asset or asset group. [This test does not exist in IAS 36.]
>
> In the case of most foreign consolidated subsidiaries, their financial statements are prepared in conformity with U.S. GAAP. [The implication is that the policies are not adjusted to achieve group uniformity, as is required by IFRS 10.]
>
> Goodwill . . . is amortized on a straight-line basis over five to twenty years. [Goodwill must not be amortized under IFRS 3, but annually tested for impairment.]

Table 11.3 Reconciliation of equity by Ono Pharmaceutical at 31 March 2013 (¥ millions)

Equity under J GAAP	423,291
Cash	+ 64865
Receivables	+ 5562
Marketable securities	− 64865
PPE	+ 6151
Intangibles	+ 17486
Other	− 9948
Equity under IFRS	442,542

Source: Prepared by the authors from published financial statements.

11.4.3 Differences revealed in reconciliations

When Japanese companies first adopt IFRS, they are required to explain the accounting differences on transition from Japanese GAAP. As an example, Table 11.3 shows the effects on the balance sheet. The two differences of "64,865" cancel out, being caused by reclassification, although this has a major effect on the appearance of the balance sheet. The intangibles difference is mostly due to the fact that, on acquisition of a new subsidiary, the acquired research and development is treated as an asset under IFRS but not under Japanese GAAP. The difference relating to PPE was caused by moving from tax-driven accelerated depreciation to the straight-line method.

There was not much effect of transition on income in this 2013 example, except for the size of actuarial losses, but that difference in GAAPs no longer applies (see Section 11.3.2).

11.5 China: regulatory issues

11.5.1 Context of accounting

Like Japan, China had a long history of centralized imperial control. Also like Japan, China borrowed codified commercial law from Western Europe (Chen, 1998; Huang, 2001). Unlike Japan, China introduced a Soviet-style uniform accounting system (see Chapter 13) which is also partly still in place. These features form the background to major changes from the late 1970s onwards.

Developments from the 1970s related to accounting in China have been driven by dramatic economic reforms, although these have not been accompanied by major political reforms. China has moved from a planned socialist model to a 'socialist market economic system'. This process began in 1978 after the Cultural Revolution ended in 1976. Examples of these economic reforms are that:

- although ownership of business enterprises remains substantially with the government, management is now separated from ownership, so that the concept of a 'business entity' is relevant;

- the banking system now allows for non-governmental loan funding to be important, and equity financing has also begun;
- large amounts of foreign investment capital have flowed into China (Davidson *et al.*, 1996).

Particularly relevant developments include that:

- by 1984 the National Central Bank had recognized and had begun regulating share issues (Winkle *et al.*, 1994);
- by the early 1990s, there were stock exchanges in Shanghai and Shenzhen;
- in 1992, a Chinese company (Brilliance China Automotive) made an initial public offering on the New York Stock Exchange;
- Chinese companies can have 'A' shares (which must be owned by Chinese), 'B' shares (which can be owned by foreigners and, from 2001, by Chinese) and 'H' shares (which are listed in Hong Kong). Some Chinese companies have also listed in the USA, the UK, Singapore and elsewhere. Companies with A shares must use the new ASBE standards that are based on IFRS, as discussed below. Companies with B shares had to use IFRS until 2007 but now use the new ASBE standards; and those with H shares could choose IFRS or Hong Kong GAAP until 2010, when the ASBE standards were also allowed.

11.5.2 Accounting regulations of 1992

The Chinese accounting system had been adapted to the economy and was based on a Soviet system of uniform accounting. It included a chart of accounts, a balance sheet based on sources and applications of funds, and the requirement to prepare many analytical schedules. Funds were provided by the state and were classified, by reference to their use, into fixed funds, current funds and special funds. Each source of funds had its stipulated application, which had to be adhered to. The system and the beginnings of reform are described by Enthoven (1987), Skousen and Yang (1988) and Zhou (1988).

Following the economic reforms, the government instituted accounting reforms, particularly in order to encourage foreign investors. In 1992, the Ministry of Finance issued four accounting regulations. These included instructions about profit distribution and auditing. The regulations of most relevance are the 'Accounting Regulations of the People's Republic of China for Enterprises with Foreign Investment' and the 'Accounting Regulations for Enterprises Experimenting with a Shareholding System'. The document 'Accounting Standards for Business Enterprises' (ASBE) came into force in 1993. It imposed some basic rules (e.g. that double-entry bookkeeping must be used, that a cash or funds statement must be included in the financial statements and that consolidated financial statements must be provided where appropriate); set out a conceptual framework (although not called that); and made some detailed rules of financial reporting. A translation of the ASBE is given in Tang *et al.* (1994).

The conceptual framework aspects of the ASBE regulation are reasonably close to US and IASC precedents (Davidson *et al.*, 1996). However, the regulation does not specifically identify the primary user or purpose of financial statements. Instead, a hierarchy of users is mentioned, which includes the government and an enterprise's

own management. This is very different from the US/IASB emphasis on financial decision-making by outside investors, although it fits a country where the government is still the most important provider of corporate finance and where loan capital is more important than equity. The ASBE framework is also based on an income/expense view rather than the asset/liability view of the US/IASB frameworks. Also of relevance is that there is still a high degree of conformity between tax and accounting figures, so that the calculation of taxable income is a major purpose of accounting. The ASBE is based on historical cost without the revaluations allowed in IFRS or the increasing use of fair value in IFRS/US rules. Furthermore, 'substance over form' was not established as a principle, and reliability took precedence over relevance. However, the Chinese system recognized the business entity and the related concept of owner's equity and profit.

It is important to note that the regulatory framework also remains quite unlike that of Anglo-American countries. The 'standards' are not written in the private sector but come from the Ministry of Finance; and the Chinese Institute of Certified Public Accountants (CICPA) is also controlled by the Ministry. CICPA was established in 1988 and has a membership of over 200,000 (see Table 1.11). About half the members work in accounting firms. A capital market regulator, the Chinese Securities Regulatory Commission, was established in 1992, modelled on the SEC of the United States.

The accounting rules of the 1992 regulations were patchy. They included the use of historical cost for fixed assets; a choice of FIFO, LIFO, etc. for inventory valuation but no 'lower of cost and market' rule; and bad debt and depreciation expenses based on tax rules. Also, the conservatism principle was inserted into Chinese regulations for the first time, and this led to several changes in later requirements. For more coverage, see Liu and Zhang (1996), Ge *et al.* (1997) and Ezzamel *et al.* (2007). In order to supplement the ASBE, a series of industry-specific 'uniform accounting systems' were implemented (Xiao *et al.*, 2004).

11.5.3 Developments after 1992

After the 1992 regulations, the World Bank provided a US$2.6 million loan in order to help the Ministry of Finance to reform the accountancy profession and to extend the accounting standards (Davidson *et al.*, 1996). The main consultant was the international accounting firm of Deloitte Touche Tohmatsu. One of its team was a former staff member of the IASC (Cairns, 1996), and there had been several contacts between IASC and CICPA.

Thirty exposure drafts were issued between 1994 and 1996, and they were generally closely in line with the standards of the IASC. The first of the resulting standards, on disclosures of relationships and transactions with related parties, was issued in 1997. In that year China joined the IASC, and became an official observer at board meetings; an IASC board meeting was held in Beijing; and the Chinese government announced its support for the IASC. Also in 1997, Hong Kong, which had begun to base its standards on IASs in 1993, was reunited with China.

In October 1998, the China Accounting Standards Committee (CASC) was founded within China's Ministry of Finance. It comprises academics and members of accounting firms as well as government experts. The CASC received a further World

Bank grant and again used Deloitte Touche Tohmatsu as consultant. Sixteen standards were issued up to early 2005. Some of these applied to listed companies only.

Also in 1998, the Ministry of Finance issued the 'Accounting System for Joint Stock Limited Enterprises', which sets out prescribed formats for financial statements (Taylor, 2000). All listed enterprises were required to consider whether there are impairments of inventories, investments and debtors. Impairments are not allowed for other types of enterprises.

In 1999 the Accounting Law, which includes coverage of such issues as corporate governance and internal control, was amended (it had originally been issued in 1985 and amended in 1993) to enhance the protection of investors. Leading from this, the State Council (an administrative legislative body of the National People's Congress) issued 'Financial Accounting and Reporting Rules' (FARR) which updated the framework of the ASBE to be more consistent with that of the IASC, particularly by introducing an asset/liability view of accounting (Pacter and Yuen, 2001). Huang and Ma (2001) provide an overview of accounting transition in China from 1949 to 2000.

In 2000, an 'Enterprise Accounting System' designed for all industries was promulgated by the Ministry, and it became effective in 2002. Part 1 of this extends the requirements for impairment accounting to most assets and introduces the concept of 'substance over form'. Part 2 contains a chart of accounts (see Chapter 14) for application across all businesses in order to improve uniformity of accounting. This approach to accounting regulation exists in parallel to accounting standards.

From 2005, an 'Accounting System for Small Business Enterprises' was available for unlisted and other small entities. This had simplified rules. Then, in February 2006, the Ministry of Finance issued a new set of ASBEs: a basic standard and 38 specific standards, largely in line with IFRS. These ASBEs are required for listed companies from 2007 and allowed for other companies. Appendix 11.1 at the end of this chapter provides the list of ASBEs.

The arrival of the ASBEs led to large changes to Chinese accounting. For example, there are fewer detailed rules (ICAS, 2010) and there are no longer industry-specific requirements. Although the new standards are based on IFRS, there are still differences from IFRS (see Section 11.6).

11.5.4 Overview of development process

It was argued by Chow *et al.* (1995) that cultural constraints would slow China down in its move towards Anglo-American accounting. Nevertheless, Xiao and Pan (1997) saw the adoption of a conceptual framework from the English-speaking world as a way of assisting in the reform of outmoded Chinese practices. The conceptual framework was seen as a way of continuing to improve standards.

In Chapter 13, there is an extensive discussion of the changes to accounting in Eastern Europe from the 1990s that followed the collapse of communism. In China, although economic reforms were dramatic, political change has been slower. Ezzamel *et al.* (2007) analyze the change in ideology from Maoism to Dengism. This allowed accounting to be seen as a neutral scientific technology. It also allowed the influence of Western concepts, including conservatism.

Xiao *et al.* (2004) argue that political factors have led China to maintain a uniform accounting system (such as the Enterprise Accounting System of 2000) although

simultaneously developing the investor-related accounting standards predicted by Nobes (1998) and Ball *et al.* (2000). Xiao *et al.* (2004) suggest that governmental influence has slowed down the rate at which an accounting system will change in response to a growing equity market.

Tang (2000) suggested that compliance by companies with the new rules was less than complete, because of a lack of training of management and auditors, and a lack of independence of auditors. Chen *et al.* (2011) examine seven Chinese accounting scandals of 1992 to 2000, commenting on the weakness of controls.

11.5.5 Audit

The fairly recent foundation of the CICPA was mentioned above. Audit is now required for a variety of enterprises, including foreign-funded enterprises, limited liability companies and many state-owned enterprises. The large international accounting firms have been rapidly growing in China, although there are some limits on them – for example, audit reports can generally only be signed by Chinese CPAs, although some foreign members of CICPA are allowed to sign under certain conditions (*Accountancy*, 1997).

Hao (1999) traces changes in the organization and regulation of the accountancy profession in China during the twentieth century and particularly from 1978. The state is still seen to exercise a large influence.

Xiao *et al*. (2000) examine the emergence of audit standards in China. DeFond *et al*. (1999) show that the new auditing rules from 1995 led to far more audit qualifications and an improvement of audit quality.

For an analysis of Chinese national auditing standards compared to international guidelines, see Lin and Chan (2000). Sami and Zhou (2008) find that the imposition of auditing standards in China increased the trading volume and price volatility of shares, suggesting that the market was better informed. China introduced new auditing standards based on International Standards on Auditing (ISAs, see Chapter 19) when it introduced the new accounting standards in 2006.

The CICPA provides an overview of the profession in China in 2015 at: http://www.cicpa.org.cn/introcicpa/about/201503/W020150410348882004213.pdf (accessed on 23 April 2015).

11.6 China and IFRS

11.6.1 An overview of differences between Chinese accounting and IFRS

The influence of the IASC/B on China has been noted above. Peng *et al*. (2008) chart the gradual change of Chinese accounting towards IFRS in new regulations of 1992, 1998, 2001 and 2006. The latest version of the standards for listed companies (see Appendix 11.1) is very close to IFRS. Nevertheless, a number of differences between these Chinese and IFRS rules remain (see Deloitte, 2006). Table 11.4 shows the important differences. This table relates to listed companies. For unlisted

Table 11.4 Some ways in which Chinese rules differ from IFRS

Incompatibilities

- ASBE 8 prohibits the reversal of all impairment losses (like US GAAP but unlike IAS 36).
- ASBE 5 generally requires measurement at cost for biological assets (like US GAAP but unlike IAS 41).

Gaps

- ASBE 9 on Employee Benefits does not deal with defined benefit plans. However, these are not widespread in China.
- ASBE 11 on Share-Based Payments does not cover cases where the entity receives an asset or where the settlement is in cash. However, such payments are rare.
- ASBE 4 and ASBE 30 have fewer requirements than IFRS 5 on held-for-sale assets and discontinued operations.

Removal of options

- ASBE 4 and ASBE 6 do not allow a choice of fair value measurement for assets (like US GAAP but unlike IASs 16, 38 and 40).
- ASBE 2 only allows equity accounting for joint ventures (like US GAAP but unlike IAS 31 which currently allows proportional consolidation).
- ASBE 16 does not allow government grants to be netted against the asset (unlike IAS 20).
- ASBE 31 does not allow the indirect method for the cash flow statement (unlike IAS 7 or US GAAP).
- ASBE 30 requires the income statement to be presented by function (whereas IAS 1 and US GAAP allow it by nature).

companies, the differences can be much greater, as they still report under the Enterprise Accounting System of 2002.

As may be seen from Table 11.4, most of the differences concern the removal of options that are available in IFRS, mostly non-US options.

11.6.2 Differences revealed in reconciliations

Cairns (1996) examined the annual reports of 18 Chinese companies listed on the Hong Kong stock exchange. As noted above, such companies have H shares and were required to publish financial statements that conform either to IFRSs or to Hong Kong rules (which are close to IFRS). Of the 18 companies, five chose IFRS and 13 Hong Kong rules. When compared with their original Chinese financial statements, the IAS statements exhibited only small adjustments, the most common being caused by a temporary problem of the treatment of currency unification. Adjustments from Chinese rules to US rules were rather more major in size. However, these adjustments have become smaller because of the new standards.

Chen *et al.* (1999) examine reconciliations between reported earnings under Chinese rules and IAS. They suggest that reported earnings were noticeably higher under Chinese rules. Chen *et al.* (2002) examine reconciliations from Chinese to IAS rules for 1997–1999 in order to discover whether the 1998 Regulation reduced

the gap between the two sets of rules. They find no evidence of this, which they put down to lack of supporting infrastructure, leading to earnings management and poor audits.

From 2007, there should be much smaller differences between IFRS and Chinese GAAP for the consolidated statements of listed companies because of the new ASBE standards. However, as a result of gaps in ASBE and some transitional issues, large differences can still show up for the companies that report under both ASBE and IFRS (because they have both A and H shares). Table 11.5 shows an unusually large example of such differences. In this case, these are mainly caused by three features of the company's accounting under ASBE:

- accounting for pensions on a cash-paid basis, thereby ignoring the liability and related expense;
- continuing to use previous valuations of certain PPE, whereas cost is used under IFRS;
- continuing to use previous tax-driven net book values for existing PPE, which had written off assets quickly so that ASBE values and depreciation expenses are now low compared to IFRS.

As may be seen from Table 11.5, ASBE earnings would have to be reduced by 69 per cent to get to the IFRS figure; and ASBE equity would have to be reduced by 54 per cent.

In the 2013 reconciliation for the same company, as shown in Table 11.6, the depreciation adjustment is still shown, but not the pension adjustment. However, a new adjustment for intangibles is shown because more intangibles were recognized under IFRS, in the context of the acquisition of Shanghai Airlines. All the reconciliations of equity are presented by the Chinese companies excluding non-controlling interests.

In passing, we can note the enormous increase in the size of the company from 2009 to 2013, which is a symptom of the dramatic growth of the Chinese economy.

Table 11.5 Differences between ASBE and IFRS for China Eastern Airlines, 2009 (millions of renminbi)

	Earnings	Equity*
Under ASBE	540	3,104
Pension obligation	(334)	(1,850)
Correcting valuation of land use rights	8	(360)
Correcting asset depreciable lives	(65)	168
Other	(8)	147
Deferred tax on the above	28	26
Under IFRS	169	1,235

Notes: *Excluding non-controlling interests
Source: Prepared by the authors from published financial statements.

Table 11.6 Differences between ASBE and IFRS for China Eastern Airlines, 2013 (millions of renminbi)

	Earnings	Equity*
Under ASBE	2,376	24,617
Correcting depreciation	(3)	49
Intangibles on business combination	–	2,242
Under IFRS	2,373	26,908

Notes: *Excluding non-controlling interests.
Source: Prepared by the authors from published financial statements.

Table 11.7 Differences between ASBE and Hong Kong IFRS for Beijing North Star, 2013 (millions of renminbi)

	Earnings	Equity*
Under ASBE	664	10,572
Reversal of investment property depreciation	125	998
Adjustment to fair value for investment properties	7	3,855
Other revaluations on reorganization in 1997	3	(9)
Under Hong Kong IFRS	799	15,416

Notes: *Excluding non-controlling interests
Source: Prepared by the authors from published financial statements.

11.6.3 Chinese companies using IFRS

A number of Chinese companies that produce IFRS reports were included in a study by Nobes and Stadler (2013). It was found that the 49 Chinese companies examined made IFRS accounting policy choices that were somewhat similar to those of UK companies, at least when compared to continental European IFRS practices (see Section 7.4). For example, many Chinese companies showed net assets in the balance sheet and held investment properties at fair value. Of course, the UK influence came via Hong Kong.

The effect of one of the IFRS options can be seen in Table 11.7, which shows the reconciliation from ASBE rules to Hong Kong IFRS by Beijing North Star Company. The adjustment is very large and concerns the use of fair value for investment properties under IFRS but cost under Chinese standards. So, this is an example of the effect of an IFRS option which is not available in ASBE standards.

SUMMARY

- China and Japan have a very long history of centralized control, followed by adoption of codified commercial legal systems. However, both have been influenced by Anglo-Saxon ideas, including recent convergence of accounting rules with IFRS, at least for listed companies.
- The government is the main influence in the financial reporting environment in Japan. There are three distinct sources of this, namely, the Companies Act, the Securities Law and the tax regulations. These three sources represent different attitudes to the purposes of financial statements.
- The accounting profession in Japan is relatively small and has had a lesser influence on financial reporting in comparison to the long-established and powerful accounting professions in the United Kingdom and the United States.
- Japan has some accounting requirements and practices that appear conservative. For example, Japanese companies are not allowed to measure fixed assets above historical cost. The most common depreciation method is reducing-balance, which results in relatively high depreciation charges in the early years of an asset's life. Japanese companies must establish a legal reserve, which is not distributable. Many companies charge expenses in their financial statements to the full extent permitted by the tax laws, even where this exceeds what is required by prudent accounting principles.
- Japanese rules changed extensively from the late 1990s to reduce the differences from US and IFRS practice. A private-sector standard-setter was established in 2001 and has continued this process.
- Nevertheless, important differences from IFRS remain, as illustrated in reconciliations from Japanese GAAP to IFRS, presented by companies adopting IFRS.
- Financial reporting in China has been transformed as a result of economic reforms. Anglo-Saxon accounting has been influential. Accounting – and the accountancy profession – is gaining in status and influence.
- Nevertheless, several older features of Chinese accounting have been retained, so that a fusion of ideas has resulted, especially for unlisted companies.
- For listed companies, a set of standards based on IFRS is required, but important differences remain between IFRS and these new Chinese standards.

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Useful websites

Accounting Standards Board of Japan	www.asb.or.jp
Japanese Institute of Certified Public Accountants	www.jicpa.or.jp
China Securities Regulatory Commission	www.csrc.gov.cn
Chinese Institute of Certified Public Accountants	www.cicpa.org.cn
World Bank, Reports on the Observance of Standards & Codes. Accounting & Auditing	www.worldbank.org/ifa/rosc_aa.html

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

11.1* 'Unlike US accounting, Japanese accounting is not a product of its environment but of outside influences.' Discuss.

11.2* Which factors could have been used at the beginning of the 1990s to predict the direction in which Chinese accounting would develop?

11.3 Compare and contrast the roles of the JICPA and the AICPA.

11.4 Discuss the causes of differences in financial reporting and its regulation (giving relevant examples of the effects) between your own country and Japan.

11.5 'Japan is unique, so Japanese accounting is unique.' Discuss.

11.6 Imagine that you are a financial analyst used to US or IFRS company statements; what difficulties would be met when assessing Japanese companies?

11.7 Discuss the classification of Japanese accounting in Nobes' (1998) model (see Figure 3.4). Which features of Japanese accounting give rise to this classification, and what have Japanese accounting and its environment in common with other countries in this group?

11.8 From your knowledge of Japanese accounting, what characteristics do you think it has in terms of Gray's (1988) model?

11.9 Why did Chinese accounting develop differently from Eastern European accounting in the 1990s? [Note: Chapter 13 examines Eastern European accounting.]

Appendix 11.1 ASBE Standards

Basic Standard

ASBE 1	Inventories
ASBE 2	Long-term Equity Investments
ASBE 3	Investment Property
ASBE 4	Fixed Assets
ASBE 5	Biological Assets
ASBE 6	Intangible Assets
ASBE 7	Exchange of Non-Monetary Assets
ASBE 8	Impairment of Assets
ASBE 9	Employee Benefits
ASBE 10	Enterprise Annuity Fund
ASBE 11	Share-based Payment
ASBE 12	Debt Restructuring
ASBE 13	Contingencies
ASBE 14	Revenue
ASBE 15	Construction Contracts
ASBE 16	Government Grants
ASBE 17	Borrowing Costs
ASBE 18	Income Taxes
ASBE 19	Foreign Currency Translation
ASBE 20	Business Combinations
ASBE 21	Leases
ASBE 22	Recognition and Measurement of Financial Instruments
ASBE 23	Transfer of Financial Assets
ASBE 24	Hedging
ASBE 25	Direct Insurance Contracts
ASBE 26	Reinsurance Contracts
ASBE 27	Extraction of Petroleum and Natural Gas
ASBE 28	Accounting Policies, Changes in Accounting Estimates and Correction of Errors
ASBE 29	Events after the Balance Sheet Date
ASBE 30	Presentation of Financial Statements
ASBE 31	Cash Flow Statements
ASBE 32	Interim Financial Reporting
ASBE 33	Consolidated Financial Statements
ASBE 34	Earnings per Share
ASBE 35	Segment Reporting
ASBE 36	Related Party Disclosures
ASBE 37	Presentation of Financial Instruments
ASBE 38	First-time Adoption of Accounting Standards for Business Enterprises

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Part IV

FINANCIAL REPORTING BY INDIVIDUAL COMPANIES

12 The context of financial reporting by individual companies

CONTENTS

12.1 Introduction
12.2 Outline of differences between national rules and IFRS or US GAAP
12.3 The survival of national rules
12.4 Financial reporting, tax and distribution
12.5 Special rules for small or unlisted companies
12.5.1 The case for special rules
12.5.2 IFRS for SMEs
Summary
References
Useful websites
Questions

OBJECTIVES

After reading this chapter, you should be able to:

- give examples of differences between national rules and the two world 'standards';
- explain why, and for what purposes, national rules are surviving;
- outline the links between financial reporting, tax and distribution of profit;
- make the case for, and explain the content of, special standards for small or private companies.

12.1 Introduction

The vast majority of companies in the world are not listed on stock exchanges. This includes nearly all the subsidiaries of listed companies. In many countries (e.g. most EU countries), these individual companies are required to publish financial reports, and are required or allowed to follow national accounting rules when doing so. In addition to all these unlisted companies, there are millions of business entities that are not set up as companies. Even if an individual entity does not publish financial statements, it still needs to do accounting for various purposes: for example, the calculation of taxable income, the calculation of legally distributable income or the provision of numbers for consolidation. National rules are generally followed for these purposes.

Francis *et al*. (2008) purport to show that, in a majority of 56 countries in a World Bank survey, most unlisted companies had adopted IFRS by 1999/2000. However, this cannot have been the case. For example, for the EU countries that they include, IFRS was generally not then legally accepted for the reporting of such companies. Their data reported on 'use' of IFRS but this must have meant something less than 'adoption' (Nobes, 2010).

Even in those cases where consolidated statements are required to follow IFRS (e.g. because the parent is listed; see Chapter 5), the unconsolidated financial statements of the parent are, in many cases, required or allowed to follow national accounting rules. In other words, the bulk of accounting going on in many countries does not follow IFRS or US GAAP.

This part of the book (Chapters 12–15) examines unconsolidated reporting. Chapters 13–15 concentrate on aspects of unconsolidated reporting in Europe, where such accounting is regulated but does not use IFRS. Chapter 13 looks at harmonization within the EU and at transition during the 1990s in Eastern Europe. Chapter 14 examines in more detail the different ways in which national rules are set, especially in France, Germany and the UK (the world's three largest economies after the US, China and Japan). Chapter 15 looks at the resulting national rules in those countries, and includes comparisons with IFRS.

Before that, this chapter provides some more general context. Section 12.2 outlines the scale of difference between national rules and IFRS or US GAAP. Section 12.3 summarizes the degree to which national rules are still used in some major countries. Section 12.4 examines the connections between financial reporting, tax and the calculation of distributable income. Section 12.5 looks at the arguments for having special rules for small or unlisted entities. Section 12.5 also introduces the IASB's standard for such companies: IFRS for SMEs.

A note on terminology may be useful here. The expression 'private entities' in the context of US or IFRS regulations means, approximately, unlisted entities, although it might exclude companies that are unlisted but which take deposits from the public, e.g. banks and insurance companies. Unfortunately, the UK contrast between public limited companies (plcs) and private limited companies is a quite different one. Most plcs are not listed; they merely have the legal right to create a market in their securities. In this book, we will use the term 'private company' in its US/IFRS sense, unless we are clearly referring to a UK legal context, as in Chapter 14.

12.2 Outline of differences between national rules and IFRS or US GAAP

Chapter 15 looks at some of the international differences in accounting rules and practices, particularly relating to unconsolidated statements. One way of illustrating these differences is to look at reconciliations from national practices to IFRS or to US GAAP. This is already done in other places in this book. Several examples were shown

Table 12.1 Reconciling items for BASF (German to US)

	Equity (million €)
As reported stockholders' equity under German GAAP	15,765.0
Minority interests	(331.8)
Stockholders' equity excluding minority interests	15,433.2
Adjustments required to conform with US GAAP	
*Capitalization of interest	472.7
*Capitalization of software developed for internal use	128.3
*Accounting for pensions	924.3
*Accounting for provisions	244.4
*Accounting for derivatives and long-term foreign currency items	3.2
*Valuation of securities at market values	191.5
Valuation adjustments relating to equity accounting	39.0
*Inventory valuation	18.9
Reversal of goodwill amortization	469.5
*Other adjustments	58.6
*Deferred taxes and recognition of tax effects of dividend payments	(810.8)
Minority interests	(13.7)
Stockholders' equity in accordance with US GAAP	17,159.1

Note: *Items marked with an asterisk are not consolidation issues.
Source: Adapted by the authors from *BASF Annual Report*, *2004*, page 93. BASF SE, Ludwigshafen, Germany. Reproduced with permission.

in Tables 1.1 and 1.2 and in Section 5.7. Also, Sections 9.3 and 9.6 include reconciliations from German rules to IFRS by Volkswagen and Deutsche Bank.

These reconciliations relate to consolidated statements. No reconciliations of unconsolidated statements are available because investors operating on an international basis would not be interested in them. For example, in the world's biggest capital market, the United States, unconsolidated statements are seldom audited or published at all. However, most of the types of adjustment in the reconciliations of consolidated statements apply equally for unconsolidated statements, the major exception being those related to goodwill.

Table 12.1 repeats part of the information given by BASF when reconciling from German to US accounting. The items marked with an asterisk are not consolidation issues. Another German chemical company, Bayer, explained the differences between IFRS and German requirements in the last year for which IFRS was not compulsory. Extracts of this are shown as Table 12.2. Again, only one of the issues relates to the process of consolidation. Several of these issues are taken up in Chapter 15. Tables 12.1 and 12.2 relate to 2004 because, in later years, German GAAP is not relevant for reporting by these groups. Nevertheless, most of the issues in these tables are still relevant differences between German GAAP and US GAAP or IFRS.

Table 12.2 Explanations by Bayer of differences between IFRS and German requirements

Financial statements prepared in compliance with IFRS aim to provide information on which investors can base their decisions. Accordingly, IFRS prescribes strict separation of commercial and tax accounting, provisions for expenses are not permitted, a different definition of realized gains is used in certain cases, recognition and valuation options are more narrowly defined, and more extensive notes and explanations are required.

Material differences relate primarily to the accounting treatment of securities, foreign currency receivables and payables, and derivative financial instruments, which under IFRS are stated at closing values whereas German accounting regulations apply the imparity principle. . . .

Both IFRS and German accounting rules stipulate that leased assets should be recognized on the basis of economic ownership. However, the definition of economic ownership varies. Under IFRS, leased assets should be recognized by the party that bears the attendant risks and rewards. . . .

Following the introduction of IFRS 3 (Business Combinations), which replaces IAS 22, goodwill arising on business combinations for which the agreement date is on or after March 31, 2004 may not be amortized but instead must be tested annually for impairment. German accounting standards continue to permit companies to amortize goodwill or offset it against retained earnings. . . .

Under IFRS, provisions may only be set up for liabilities to third parties. Pension provisions are calculated using the projected unit credit method, taking into account future increases in remuneration and pensions. The German tax-based method is not permitted. . . .

Deferred taxes must also be recognized for loss carryforwards if it is sufficiently probable that these loss carryforwards can be utilized. German accounting rules do not permit capitalization of deferred tax assets resulting from tax loss carryforwards.

Source: Adapted from *Bayer AG Annual Report, 2004*. Bayer AG, Leverkusen, Germany. Reproduced with permission.

12.3 The survival of national rules

The distinction between adoption of IFRS and convergence with IFRS was examined in Chapter 5. There are several reasons why a country might not wish to adopt IFRS for some or all purposes, such as:

- unwillingness to lose control of rule-making;
- political or cultural opposition to IFRS because it is written in English and outside of the legal system;
- concluding that IFRS is too complex and requires too many disclosures or, in the case of the SEC, concluding the reverse;
- not wanting to separate tax and financial reporting (and not wanting tax to be based on IFRS);
- a view that IFRS contains too many options and not enough detailed guidance.

The most obvious case of non-adoption of IFRS is the United States, where the SEC does not yet accept IFRS for domestic registrants. Interestingly, as the SEC only imposes reporting requirements on registered companies, the great bulk of US corporations fall outside of its control. Also, the SEC is only interested in consolidated financial statements, so it imposes no requirements for accounting by the individual parent or subsidiary companies of its registrants. To the extent that US accounting is done beyond the consolidated statements of SEC-registrants, there are no publication or audit requirements. In many cases, companies nevertheless prepare full-scale US GAAP for their lenders or shareholders, and profit calculations are still necessary as the starting point for taxation (see Section 12.4).

In Japan, the feeling of national uniqueness leads to reluctance to abandon national rules. For example, the Japanese were opposed to the abolition of pooling/merger accounting (see Chapter 8) because, culturally, they like to present combinations as agreed mergers rather than as contested takeovers. This slowed down convergence with IFRS (IASB, 2005). In some parts of the EU, national pride also leads to a distaste for US GAAP or for IFRS, which is seen as a Trojan horse concealing Anglo-Saxon accounting (see Chapter 4). However, there are better reasons for caution in the adoption of IFRS for unconsolidated statements. The basic point is that the purpose of accounting may differ between a listed company's consolidated report and other accounting. For example, an unlisted company may have no shareholders beyond its directors. Full-scale IFRS reporting might be disproportionately expensive for it. These issues are examined in Section 12.5.

Furthermore, the main purposes of unconsolidated accounting may be to calculate taxable income or distributable income rather than to give useful information to investors to help them to predict cash flows. Perhaps such accounting *should* be different from IFRS. In those EU countries where tax and financial reporting have been closely linked (see Section 12.4), there is an understandable reluctance to adopt IFRS for unconsolidated statements because the resulting profit figure is more judgemental. Also, in effect, a country would be delegating the calculation of taxable income to the IASB, which has no interest in that topic.

Table 12.3 gives some examples of the response of EU countries to permission from the EU Regulation 1606/2002 to use IFRS for unconsolidated statements. To

Table 12.3 Some reactions of EU countries to the possibility of using IFRS for unconsolidated statements

Compulsory use	Cyprus
Listed compulsory (from 2009), unlisted optional*	Denmark
Optional*	UK, Netherlands, Norway
Listed compulsory, unlisted banned*	Czech Republic
Optional but only for financial reporting	Germany
Banned	Austria, Belgium, France, Spain, Sweden

Notes: *Implication of two different starting points for taxable income.
Source: Compiled by authors.

take the example of Germany, companies are allowed to use IFRS for unconsolidated reporting but only if they also prepare statements under national rules for tax and distribution purposes (Haller and Eierle, 2004). This issue is taken further in Section 12.4, below. Countries in the bottom half of the table are those with stronger tax/reporting links. It should be noted that these countries are on the right of the classifications in Chapter 4. Sellhorn and Gornik-Tomaszewski (2006) and Nobes (2008) have commented on the way in which the reactions of EU countries to IFRS could have been predicted by previous classifications of the sort examined in Chapter 3.

Even those countries that allow the use of IFRS for unconsolidated statements have mostly maintained national rules. However, in some cases, for example the UK, substantial programmes of convergence with IFRS were undertaken from the late 1990s, followed by approximate adoption of IFRS for SMEs as national GAAP.

12.4 Financial reporting, tax and distribution

As explained in Chapter 2, profits under normal accounting rules are the starting point for the calculation of taxable income and distributable income in any country. However, the degree of closeness varies greatly. Lamb *et al.* (1998) examine several accounting topics and suggest that reporting and tax are much closer in France and Germany than in the US or the UK. Oliveras and Puig (2005) and Gavana *et al.* (2013) use the same methodology and show some reduction in tax influence in Spain and Italy, respectively. Nobes and Schwencke (2006) study how the links between reporting and tax develop over a century, using Norway as an example of a country where the gap has widened.

In countries where reporting and tax rules are identical, the theoretical legal position that tax should use reporting rules tends to become reversed, such that accounting numbers are chosen with their tax effect in mind. This described the position under German national rules (Haller, 1992). Such a close linkage also makes it impossible in practice for a country to adopt or fully converge with IFRS because IFRS profit is more subjective and the rules are beyond national control. The use of IFRS implies that the close linkage must be broken and that accounting must be done twice.

In countries where some or all companies have an option to choose between IFRS and national accounting rules for financial reporting, a further complication arises: a company is allowed to have two different measures of pre-tax profit and therefore two different starting points for the calculation of taxable income. Such cases are shown with an asterisk in Table 12.3. This might not be a problem for a country which has special tax rules on many accounting topics (see the discussion in Section 2.5), but there could still be a difficulty where tax practice rests upon accounting rules for particular topics. For example, under IAS 32 (see Section 6.4), certain payments are re-classified as dividends rather than interest, or vice versa. The issue here is whether the amount of ‘interest’ that is tax deductible will follow the classification for financial reporting. The answer can vary internationally.

The amount of legally *distributable* income is also the same as the accounting profit for individual legal entities in many countries (e.g. France and Germany). Under the

EU's Second Directive, distributable profit is 'cumulative realised profit less cumulative realised losses'. In the UK, adjustments are made to accounting profit, for example to add back any depreciation expense caused by having voluntarily revalued assets upwards in the past. However, a move to IFRS by individual companies (which are the ones that can distribute profit) can presumably affect what is regarded as realized.

In the USA, the restraint on distribution rests on solvency measures rather than on profits, which might be a better solution for Europe.

12.5 Special rules for small or unlisted companies

12.5.1 The case for special rules

There is a long history of 'big GAAP versus little GAAP' or 'differential reporting' (Keasey and Short, 1990; Jarvis, 1996; Evans *et al*., 2005; Eierle, 2005). An obvious example is the SEC's imposition of US GAAP on listed companies only, as noted in Section 12.3. In 2007, the FASB and the AICPA set up a body (the Private Company Financial Reporting Committee) to consider accounting by private companies, many of whom prepare financial reports for shareholders or lenders. In 2011, the Financial Accounting Foundation (which oversees the FASB) set up a working group to examine how to simplify US GAAP for private companies. It did not recommend adopting IFRS for SMEs, but that a special version of US GAAP should be created. The Private Company Council, set up in 2012, has not led to any changes to GAAP so far.

In the EU, small companies can be exempted from audit and publication under national laws based on the Fourth Directive on company law, which was issued in 1978. For this purpose, 'small' is related to having below 50 employees and to monetary values of turnover and total assets that have been raised from time to time (see Section 14.3). In 2009, the EU Commission issued a consultation paper designed to reverse the logic of the Fourth and Seventh Directives. That is, the Directives would address accounting for small companies first, and then add some requirements for larger ones. This resulted in a revised Directive in 2013, which has gradually been followed by changes to EU laws. Among other things, the Directive (Article 16) limits the number of notes that the law can require small companies to publish.

Also importantly for the topic of this chapter, the Commission published in 2009 a draft of an amendment to the Fourth Directive, designed to allow member states to exempt 'micro' entities from many of the requirements of the Directive. This was issued in 2012, with 'micro' being defined as entities not falling above two of the three criteria: 10 employees, and thresholds of sales and assets. As most EU companies fall below these criteria, these provisions are leading to major change, depending on how member states enact the exemption and what rules, if any, they impose instead.

As well as special provisions in law for unlisted or small companies, some countries have special versions of their accounting standards for small companies. The UK, Hong Kong, Malta and New Zealand are examples. The UK's Financial Reporting Standard for Smaller Enterprises (FRSSE), originally issued in 1997, abbreviated the main standards and reduced the disclosure requirements of UK GAAP. 'Small' is defined using the legal basis mentioned in the previous paragraph. The key issue is

that the measurement rules of the main standards were not significantly affected. Also, if small companies have an accounting problem not covered by the FRSSE, they must refer to the main standards. The FRSSE was revised in 2013 when old UK GAAP was replaced by a version of IFRS for SMEs. It is no longer available from 2016 onward but FRS 105 is available for micro entities.

A rather different idea was pioneered in Australia. For some unlisted companies, the main objection to IFRS is not the accounting rules but the large number of disclosure requirements. The information must not only be prepared and disclosed but also audited. This can be costly and intrusive. In Australia, in 2010, a special version of IFRS was issued as an optional basis for companies without public accountability that are nevertheless required to report. These 'Reduced Disclosure Requirements' do not change any of the accounting rules but considerably reduce the disclosure requirements.

A similar idea was introduced for the UK and Ireland in 2012. A standard called FRS 101 ('Reduced Disclosure Framework') is identical to EU-endorsed IFRS except for reduced disclosure requirements. It is designed for unconsolidated reporting by subsidiaries and parents in groups which prepare consolidated statements using EU-IFRS.

12.5.2 IFRS for SMEs

Throughout the life of the old IASC, the standards were written largely with one type of reporting in mind: consolidated statements of large listed companies. However, in the early years of the IASB, a demand began for a version of IFRS suitable for SMEs. IASB began the project in 2003, against the wishes of some of its board members and senior technical staff who thought that it would divert attention from their main task. As a result, in order to protect the project, the staff member in charge of it (Paul Pacter) reported directly to the IASB's chairman.

In countries that abandoned national GAAP in favour of IFRS, a version of IFRS for smaller or unlisted entities is a useful as a way of reducing burdens on such entities. Indeed, South Africa was so keen on this that it adopted the IASB's exposure draft (see below) as its standard for unlisted companies. However, it is not immediately clear why an *international* standard would be relevant for countries such as France or Germany where IFRS is only used for consolidated statements, and where accounting is closely linked to tax. Nevertheless, the European Commission was at the forefront in arguing for an SME version of IFRS. This was partly with a view to eventual standardization of accounting and then a common European tax base. These objectives are quite different from the IASB's aim of international comparability for investors. One result is that the Commission has wanted an SME standard to contain more simplifications (i.e. measurement differences from IFRS) than the IASB was inclined to allow.

The issue of differential measurement bases slowed down the IASB's project. In 2004, a Discussion Paper was issued. As a result of the feedback from this, the IASB decided, in principle, to allow some measurement differences on the basis of assessing costs and benefits. Very few differences were included in the exposure draft of 2007, but several were added into the final standard of 2009, as explained below.

Despite the project's SME title, it was decided that the key point is not size but whether the reporting entity is of public interest, and especially whether it is listed.

The exposure draft was intended for entities that are not publicly accountable, i.e. that are not listed and that do not carry out fiduciary activities such as a bank or insurance company. During 2008, the title of the project was 'private entities', but in January 2009, this was changed to 'non-publicly accountable entities' (NPAEs). However, although this remains the scope, the title reverted to SMEs for the standard, partly because 'NPAE' was ungainly and because 'private' is confusing (e.g. in China where many companies are partly owned by the government). Ram and Newberry (2013) examine the process through which the IASB went when writing the IFRS for SMEs.

The IFRS for SMEs is 230 pages long (plus guidance and basis for conclusions), compared to about 1,400 for full IFRS (plus guidance and bases for conclusions). It is also better written, so it is much easier to read. Approximately speaking, each chapter in the SME standard covers one standard in full IFRS. A few whole standards are left out: segment reporting (IFRS 8), earnings per share (IAS 33) and interim reporting (IAS 34). Otherwise, there are many reductions in disclosure requirements, some options are deleted and others are added, and there are several simplifications compared to IFRS.

Table 12.4 shows the simplifications in IFRS for SMEs that create differences from IFRS, without adding options. Some of these differences involve replacing options in IFRS with compulsory treatments. This is the case for the IAS 40 issue in Table 12.4.

Table 12.4 IFRS for SMEs: differences from IFRS (other than additional options)

Standard in full IFRS	Simplification in IFRS for SMEs
IAS 12	Recognition of deferred tax liabilities on unremitted earnings of associates and joint ventures only if probably to be paid in the foreseeable future.
IAS 16	No continuous review of residual values of assets for depreciation calculations.
IAS 20	Government grants treated as income when receivable.
IAS 21	No re-classification of foreign currency gains/losses as income when foreign subsidiaries are sold.
IAS 23	Borrowing costs on construction should be expensed.
IAS 38	All development costs should be expensed.
IAS 38	Intangibles cannot be measured at fair value.
IAS 38/IFRS 3	Goodwill and other intangibles with indefinite life to be amortized over a period of up to 10 years.
IAS 39	No available-for-sale category of financial assets (so, only amortized cost or marking-to-market).
IAS 40	Instead of the choice between cost and fair value (as in IFRS), fair value should be used when and only when it can be measured without undue cost or effort.
IFRS 5	No held-for-sale category of formerly non-current assets.
IFRS 10	Subsidiaries acquired with the intention of sale within one year should be excluded from consolidation.
IFRS 15	More extensive use of taking revenue over time on contracts.

For IAS 20, a choice of options in IFRS is replaced by a completely different requirement in IFRS for SMEs. Two other complex IFRS options were deleted: measurement of PPE or of some intangibles at fair value. However, the PPE option was added to IFRS for SMEs in 2015, as explained below. As well as removing complex options, IFRS for SMEs introduced several extra simplifying options, as shown in Table 12.5.

Some commentators had argued for further simplifications, e.g. treating all leases as operating leases, and not accounting for deferred tax. There was a difference between IFRS and IFRS for SMEs on deferred tax, because IFRS for SMEs had used the basis in an exposure draft to amend IAS 12, which had been later abandoned. This problem was resolved by amending IFRS for SMEs to the IAS 12 basis in 2015.

There is just one topic for which private entities might use full IFRS. That is, they are allowed to use full IFRS for measurement and recognition of financial instruments (i.e. to use IAS 39 or IFRS 9) instead of the simpler version summarized in Table 12.4.

The IFRS Foundation set up an SME Implementation Group (SMEIG) in 2010. It assists the IASB in supporting the implementation of the IFRS for SMEs. In April 2011, the SMEIG issued three draft non-mandatory 'Questions and Answers', designed to be the beginning of a series of such aids to implementation. However, in Europe at least, these were criticized as being the start of a process that would lead to the IFRS for SMEs being surrounded by a lot of detailed written guidance, which would defeat its original purpose. However, by early 2015, only seven 'Questions and Answers' had been issued in final form.

In 2013, the IASB issued an exposure draft of proposed amendments to IFRS for SMEs, followed by revisions to the standard in 2015. However, there were few important changes. Those of some significance were:

- introducing an option to measure PPE at fair value;
- introducing an exemption from having to measure equity instruments at fair value if this would involve 'undue cost or effort' (e.g. for unlisted shares);
- for goodwill and for other intangibles whose life cannot be estimated, changing from 10-year amortization to a *limit* of 10 years for amortization; and
- aligning the deferred tax basis with that in IAS 12.

Table 12.5 Additional options in IFRS for SMEs

Standard in full IFRS	Option in IFRS for SMEs
IAS 1	Can combine Statement of Comprehensive Income and Statement of Changes in Equity, under certain circumstances, as Statement of Income and Retained Earnings.
IAS 19	Simplified calculation of pension obligation, e.g. not taking account of expected salary increases.
IAS 27	Parents exempted from preparing investor statements.
IAS 28	Associates and joint ventures can be carried at cost or fair value in consolidated statements (instead using the equity method).

By March 2015, 53 countries had adopted the IFRS for SMEs for companies not using IFRS. These included Israel, Peru and South Africa. In a few countries (e.g. Hong Kong and Singapore), the adoption involved slight amendment. In some other countries, IFRS for SMEs is an allowed alternative to national GAAP. The IASB outlines the use of IFRS for SMEs at: http://www.ifrs.org/Use-around-the-world/Pages/Analysis-of-SME-profiles.aspx.

Adoption of IFRS for SMEs has not happened in other countries for various reasons. For example:

- in the US, the lack of requirements for reporting by unlisted companies makes IFRS for SMEs less relevant;
- in Australia, reduced disclosures are regarded as a better solution, rather than having two different GAAPs;
- in France, Germany and Japan, adoption of IFRS for SMEs would change taxable and distributable income.

Some of the major differences between the IFRS for SMEs and other major GAAPs are shown in the synoptic table that is presented as the first appendix to this book.

SUMMARY

- Much of the financial reporting done in the world still uses national rather than international rules.
- There are still many accounting topics where international differences survive, including accounting for intangible assets, for pensions and other provisions, and for financial instruments.
- National rules survive for several reasons, including reluctance to change and resistance to 'foreign' influences. Better reasons could include the greater suitability of national rules for tax and distribution calculations.
- Reduced requirements for smaller or for unlisted companies are a feature of some national rules.
- The IASB's standard for SMEs relates particularly to companies that are not publicly accountable. The standard is much shorter than full IFRS. Some measurement 'simplifications' are included. It has been extensively adopted.

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Useful websites

The IFRS for SMEs can be studied at: http://www.ifrs.org/IFRS-for-SMEs/Pages/IFRS-for-SMEs.aspx. The most relevant US site is: http://www.fasb.org/pcc.

The websites listed at the ends of Chapters 6, 8 and 14 may also be useful for various aspects of this chapter.

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

12.1* Using information from this chapter and earlier ones (e.g. Chapters 2, 3 and 5), give examples of accounting topics on which there are major differences between two national accounting systems or between a national system and IFRS.

12.2* Are the arguments for differential reporting convincing? Should differentiation be made on the basis of company size or using some other characteristic?

12.3 From this and earlier chapters, explain how financial reporting profit can differ from taxable income, and how this varies internationally.

12.4 Explain how the IASB's standard for private entities differs from full IFRS. In your opinion, does it differ enough?

12.5 Suggest reasons for the adoption or non-adoption of IFRS for SMEs in China, France, Japan, South Africa and the United States.

13 Harmonization and transition in Europe

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OBJECTIVES

After reading this chapter, you should be able to:

- explain why harmonization of financial reporting was undertaken by the EU;
- outline the content and effects of the EU's Fourth Directive;
- contrast the process and progress of EU harmonization with that of the IASB (as outlined in Chapter 4);
- explain how financial reporting in Central and Eastern Europe responded to the transition from command economies to market economies;
- outline the problems of applying IFRS in Central and Eastern Europe.

13.1 Introduction

Chapter 12 examined various issues relating to financial reporting by individual companies around the world. For some countries this is not an important issue for study. For example:

- in the USA, the only type of reporting that is generally required and regulated is consolidated reporting by listed groups;
- in Australia and Canada, although there is some regulated reporting beyond listed groups, the Australian or Canadian versions of IFRS are used for this purpose, although there are reduced disclosure requirements in Australia for reporting entities without public accountability.

The special rules for the reporting of Chinese and Japanese individual companies were looked at in Chapter 11. In Chapter 12, it was noted that some countries use the *IFRS for SMEs* for individual company reporting. However, this leaves one major group of countries where individual company reporting is regulated but does not generally use IFRS or IFRS for SMEs, i.e. Europe. This chapter starts with harmonization of accounting within the European Union (as introduced in Chapter 4), and then looks at transition in Eastern Europe. In both cases, we concentrate on individual company accounting.

The history of financial reporting in Europe provides a striking example of the influence of political and economic change on accounting rules and practices. The political map of Europe is dominated by the member states of the European Union (EU) including the successor states of the Soviet Empire. Since the admission of 10 of the latter to the EU in 2004 and 2007, there has been considerable overlap between the two categories of countries. In this chapter we discuss the effects of these political changes on first the process of accounting harmonization within the EU and then the problems of financial reporting within the transition economies of Central and Eastern Europe, both those economies within the EU (e.g. Poland and Hungary) and those outside (notably the Russian Federation).

In Section 13.2, the EU's efforts at harmonization, beginning in the 1960s, are examined. These remain relevant because national laws still apply compulsorily or optionally for some purposes in most EU countries. This is particularly the case for unconsolidated financial statements, which are the basis for the calculation of taxable income and distributable income. Chapter 5 has already looked at the relevance of the EU in the context of the compulsory use of IFRS for the consolidated statements of listed companies. Section 13.3 examines the process of transition from communist to capitalist accounting that took place in Eastern Europe from the 1990s.

13.2 Harmonization within the European Union

13.2.1 Reasons for and obstacles to EU harmonization

What is now known as the EU was established on 1 January 1958 following the Treaty of Rome of 1957. The six founding members were France, the German Federal

Republic, Italy and the three Benelux countries (Belgium, the Netherlands and Luxembourg). They were joined in 1973 by the UK, Ireland and Denmark; in 1981 by Greece; in 1986 by Portugal and Spain; in 1995 by Austria, Finland and Sweden; in 2004 by Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia; in 2007 by Bulgaria and Romania; and in 2013 by Croatia. The population of the EU is approximately 510 million. From an accounting point of view (and many others), the early years of the EU were dominated by France and West Germany. The entry of the UK and Ireland in 1973 introduced Anglo-Saxon ideas of financial reporting. The entry of the other countries has not had much effect on the content of harmonizing Directives and Regulations, but has presented several member states with difficulties of implementation. The process of accession to the EU, with particular reference to accounting and auditing, is discussed by Day and Taylor (2005).

The drive for harmonization of accounting and financial reporting derived initially from the Treaty of Rome. The objects of the Treaty include the establishment of the free movement of persons, goods and services, and capital. This involves the elimination of customs duties, the imposition of common tariffs to third countries and the establishment of procedures to permit the coordination of economic policies. More specifically, the Common Industrial Policy of 1970 called for the creation of a unified business environment, including the harmonization of company law and taxation, and the creation of a common capital market.

The activities of companies extend beyond national frontiers, and shareholders and other stakeholders need protection throughout the EU. In order to achieve this and to encourage the movement of capital, it is necessary to create a flow of reliable homogeneous financial information about companies from all parts of the EU. In the end, this objective led to the Regulation of 2002 that imposed IFRS for the consolidated statements of listed companies, as discussed in Chapter 5. Further, because companies in different EU countries exist in the same form and are in competition with each other, it is argued that they should be subject to the same laws and taxation.

The obstacles to harmonization of financial reporting and company law were discussed in Section 4.2. Of particular importance here are the fundamental differences between the contexts and purposes of the various national accounting systems in the EU. They include the differences between creditor/secrecy in the traditional Franco-German systems and investor/disclosure in the Anglo-Dutch systems; and between law/tax-based rules and private sector standards. These large differences have contributed towards the great variations in the size and strength of the accountancy profession. The smaller and weaker professional bodies in Franco-German countries were an obstacle to movements towards accounting and auditing of an Anglo-Dutch type (see Chapter 2).

Sections 13.2.2–13.2.5 detail the slow achievement of some harmonization of financial reporting and auditing throughout an expanding EU during the 1960s, 1970s and 1980s. In the 1990s the European Commission turned its attention to financial services, launching a Financial Services Action Plan (FSAP) in 1999 and commissioning the Lamfalussy report of 2001. The Committee of European Securities Regulators (CESR) was established in 2001; reformed in 2011 as the ESMA. The IFRS Regulation was passed in 2002. The Directives were revised in 2013.

13.2.2 Directives and Regulations

The EU attempted to harmonize company law and financial services through two main instruments: Directives, which must be incorporated into the laws of member states; and Regulations, which become law throughout the EU without the need to pass through national legislatures. The Directives and Regulations on company law and financial services that are relevant to corporate accounting are listed in Table 13.1, which also gives a brief description of their scope. The Regulation of 2002 on the use of IFRS has already been examined in Chapter 5. The Fourth and Seventh company law Directives are of the most relevance (see Chapter 16 for the latter, which deals with group accounting). The Fourth will be discussed in some detail below, after an outline of the procedure for setting Directives and Regulations. In 2013, the Fourth and Seventh Directives were combined and revised, though without major change to their content.

First, the European Commission, which among other things is the EU's permanent civil service, decides on a project and asks an expert to prepare a report. In the case of the Fourth Directive, this was the Elmendorff Report of 1967. Then an *avant projet* or discussion document is prepared. This is studied by a Commission working party and leads to the issue of a draft Directive, which is sent to the European Parliament (a directly elected assembly) and commented on by the Economic and Social Committee (a consultative body of employers, employees and others). A revised proposal is then submitted to a Working Party of the Council of Ministers. Parliament decides whether the proposal should be adopted, but the Council – consisting of the relevant ministers from each EU country – must give its final approval. In the case of a Directive, member states are required to introduce a national law within a specified period, though they often exceed it, as discussed below in the case of the Fourth Directive. Table 13.1 includes UK implementation dates, as an example. Later, we show the dates of implementation of the Fourth and Seventh Directives for a wider range of countries. For an analysis of the process of setting accounting Directives, see Diggle and Nobes (1994).

13.2.3 The Fourth Directive

This sub-section examines the content of what was, until 2013, the Fourth Directive. It dealt with unconsolidated financial statements, which it called 'annual accounts'. The content of the Fourth Directive, with slight amendment, was greatly re-arranged in 2013. The re-arranged version starts with the rules for smaller companies, and then adds requirements for larger companies. The exact effects of a Directive on a particular country will depend upon the laws passed by national legislatures. For example, there are dozens of provisions in the Directive that begin with such expressions as 'member states may require or permit companies to …'. Given this flexibility, the effects on accounting differ country by country (see Chapter 15). However, we consider here the general outline of the Directive and the process whereby it took its ultimate form.

The Directive (originally EC Commission, 1978, now contained in EU, 2013) covers public and private companies in all EU countries. Its articles include those referring to valuation rules, formats of published financial statements and disclosure

Table 13.1 Directives and Regulations relevant to corporate accounting

Directives	Date adopted	UK law	Topic
First	1968	1972	Ultra vires rules
Second	1976	1980	Separation of public companies, minimum capital, distributions
Third	1978	1987	Mergers
Fourth*	1978	1981	Formats and rules of accounting
Fifth	–	–	Structure, management and audit of companies
Sixth	1982	1987	De-mergers
Seventh	1983	1989	Consolidated accounting
Eighth	1983, 2006	1989, 2006	Statutory audit
Tenth	–	–	International mergers of public companies
Eleventh	1989	1992	Disclosures about branches
Twelfth	1989	1992	Single member company
Accounts Modernization	2003	2006	Modernization and update of 4th and 7th Directives
Transparency	2004	2006	Transparency in EU capital markets
Takeovers	2005	2006	Cross-border takeovers within the EU
Regulations			
European Economic Interest Grouping	1985	–	Business form for multinational joint ventures
International Standards	2002	–	Use of IFRS and a mechanism for their endorsement
Societas Europaea	2004	–	European company subject to EU laws

Note: *Special versions of the Directive for banks and insurance companies were adopted in 1986 and 1991, respectively.

requirements. It did not cover consolidation: that was left for the Seventh Directive. The Fourth Directive's first draft was published in 1971, before the United Kingdom, Ireland and Denmark had entered the EU in 1973 or had representatives on the *Groupe d'Etudes* (see below). This initial draft was heavily influenced by German company law, particularly the *Aktiengesetz* of 1965. Consequently, valuation rules were conservative, formats were prescribed in rigid detail, and disclosure by notes was very limited. Financial statements were to obey the provisions of the Directive.

The influence of the United Kingdom and Ireland on the Commission, Parliament and *Groupe d'Etudes* was such that a much amended draft was issued in 1974. This introduced the concept of the 'true and fair view'. This process continued and, by the promulgation of the final Directive, the 'true and fair view' was established as a predominant principle in the preparation of financial statements (Art. 2, paragraphs 2–5; now Art. 4). In addition, the four principles of the UK's SSAP 2 (accruals, prudence, consistency and going concern) were made clearer than they had been in the

1974 draft (Art. 31; now Art. 6). The translation of the 'true and fair view' and its differing effects in various countries have been extensively discussed (e.g. Alexander, 1993; Ordelheide, 1993; Nobes, 1993; Aisbitt and Nobes, 2001; Evans *et al.*, 2015).

Another change by 1974 was that some flexibility of presentation had been introduced. There is a choice of two balance sheet formats (Art. 8; now Art. 9). There were also four income statement formats (Art. 22): horizontal and vertical versions of 'by nature' and 'by function' formats. These have been reduced to the two vertical formats in the 2013 revision (Art. 13). National implementations of these formats can be seen in Chapter 15. More re-arrangement and summarization of items in the financial statements were made possible in the 1974 version (Art. 4; now Art. 9). The Directive did not (and still does not) mention cash flow statements, as these were not prepared in any member state by 1974, although the UK introduced a version in an accounting standard of 1975 (SSAP 10).

Another concern of Anglo-Dutch accountants has been with the effect of taxation on Franco-German accounting. Extra disclosures called for by the 1974 draft about the effect of taxation were included in the final Directive (Arts. 30 and 35; now Art. 17). The fact that member states may permit or require a type of inflation accounting (an important topic in the 1970s) was treated in more detail than in the 1974 draft (Art. 33; now Art. 7), although the Directive remains based in historical cost. Choice is also allowed for determining the cost of inventories (FIFO, LIFO or weighted average) (Art. 40; now Art. 12). On many other accounting topics there are no rules at all, such as lease accounting, long-term contracts and currency translation. On liabilities, the Directive allows recognition even if there is no present obligation (Art.20; now Art. 12). Conversely, pension obligations do not need to be recognized (Art. 43; now Art. 16).

There were also requirements for more notes in the 1974 draft than in the 1971 draft, and more in the final Directive than in the 1974 draft (Arts. 43–46; now Arts. 15–18). Another feature of the Directive which derived from German law was the splitting of companies into three categories by size, measured in terms of sales, balance sheet total and number of employees. Member states are allowed to offer various simplifications of formats and disclosures to smaller companies. In the 2013 version of the Directive, member states are not allowed to impose note disclosures on small companies beyond a list of eight items.

The Fourth Directive was supposed to be enacted in member states by July 1980 and to be in force by January 1982. No country managed the former date, as may be seen in Table 13.2, which includes implementation dates for those countries that had become members of the EU by the beginning of 2004.

For the United Kingdom, Ireland and the Netherlands, the changes included compulsory formats and detailed valuation requirements (Nobes, 1983). In other countries the introduction of the 'true and fair view' as an overriding requirement, the requirements for extra disclosures, and the extension of publication and audit to many more companies were significant (see Chapter 14).

It is clear that neither asset valuation, nor formats, nor disclosure were completely standardized as a result of the laws consequent upon the Fourth Directive. As explained above, there are many choices in the Directive, and many topics were omitted. However, *harmonization* was noticeable. Also, several other countries (e.g. Switzerland and Poland) made legal changes that were strongly influenced by the

Table 13.2 Implementation of accounting Directives as laws

	Fourth	Seventh
Denmark	1981	1990
United Kingdom	1981	1989
France	1983	1985
Netherlands	1983	1988
Luxembourg	1984	1988
Belgium	1985	1990
Germany	1985	1985
Ireland	1986	1992
Greece	1986	1987
Spain	1989	1989
Portugal	1989	1991
Austria*	1990	1990
Italy	1991	1991
Finland*	1992	1992
Sweden	1995	1995
Norway†	1998	1998

Notes: *Some amendments to these laws were necessary for full implementation.
†A member of the European Economic Area, but not of the EU.

Directives, in some cases as preparation for membership of the EU. Members of the European Economic Area that are not part of the EU (e.g. Norway) were also obliged to implement the Directives.

In the area of valuation, there was a very loose compromise between the opinions of those countries that were in favor of adjustments for price changes (the Netherlands, at one extreme) and those that were against them (Germany, at the other extreme). Member states may allow various forms of revaluation. There is a requirement that the difference between the adjusted figures and historical cost must be shown.

European professional accountancy bodies have naturally taken a great interest in harmonization and have set up institutions to monitor and influence its progress (see Section 4.4). The most important body at present is the *Fédération des Experts Comptables Européens* (FEE), which advises the European Commission on company law and accounting harmonization. One of FEE's predecessors (the *Groupe d'Etudes*) accepted in the 1970s the dominance of 'true and fair' and the need for consolidation; this may have helped in their acceptance by the Commission.

In 1990, the EU established a Forum of European standard-setters, which discussed issues not covered by the Directives, for example, lease accounting and foreign currency translation. However, it was also made clear that further accounting Directives were unlikely; and the Forum was little more than a discussion group. It was closed down in 2001. In 1995, the EU gave public backing to the IASC, as discussed earlier (see Chapter 4 and Gornik-Tomaszewski, 2005).

In 2001, the first substantial amendment to the Fourth Directive since its adoption in 1978 allowed the requirements of IAS 39 relating to the fair valuation of financial

instruments (see Chapter 6), so that EU companies could obey the Directives and the standard at the same time. In 2003, the Accounts Modernization Directive allowed more extensive use of fair values and removed many other incompatibilities with the standards of the IASB. This is a separate issue from the EU requirement for some companies directly to use IFRS for consolidated statements.

In 2009, there were two developments, which have now come to fruition. First, as part of trying to reduce burdens on companies, the Commission published a draft of an amendment to the Fourth Directive that would allow member states to exempt most companies entirely from its requirements. These companies are 'micros' with 10 or fewer employees (see Section 12.5 for more detail). This amendment was finalized in 2012. Secondly, and related to this, the Commission issued a consultation document proposing to rearrange the Directive so that it set out basic instructions and then added some more for larger/public companies. This led to the re-arranged Directive of 2013, as mentioned several times above.

The Directive is still having a major effect on developments in accounting in the EU. For example, as was explained in Chapter 12, the IASB's *IFRS for SMEs* cannot be directly implemented in any EU member state because it is inconsistent with the Directive and therefore with national laws.

13.2.4 The European company and the EEIG

One of the Regulations in Table 13.1 concerns a type of company which is registered as an EU company and subject to EU laws. It is called a *Societas Europaea* (SE), which is Latin for European Company. Despite pressure from the Commission, progress on this Regulation was very slow, partly because member states did not wish to lose sovereignty over companies operating in their countries, and partly because member states found it difficult to agree upon a company structure with respect to worker participation on boards of directors. The Regulation was finally adopted in 2004. Several large European companies have become SEs, notably German-based multinationals such as Allianz and BASF. There are over 150 SEs in Germany alone (du Plessis *et al.,* 2012, page 7). In 2007, the Commission consulted business on a possible European Private Company Statute, but this has not come to fruition at the time of writing.

It was easier to agree upon proposals for a form of joint venture organization for EU companies. The Regulation on the 'European Economic Interest Grouping' is based on the French business form, the *groupement d'intérêt économique*. It provides a corporate organization that can be smaller and of shorter duration than the SE. Members of a grouping are autonomous profit-making entities, whereas the grouping itself provides joint facilities or enables a combination for a specific purpose (McGee and Wetherill, 1989).

13.2.5 Other Directives

The Second Directive concerns a number of matters connected with share capital and the differences between public and private companies (see Nobes, 1983). The Seventh Directive (now included with the content of the Fourth in the revised Directive of 2013) concerns consolidated accounting, and is considered in Chapter 16.

The original Eighth Directive was watered down from its original draft, which might have greatly affected the training patterns and scope of work of accountants, particularly in the United Kingdom. Its main effect has been to decide on who is allowed to audit accounts in certain countries that have small numbers of accountants, such as Denmark and Germany. Some changes to auditor independence and audit firms also occurred (e.g. see Evans and Nobes, 1998a and 1998b).

Partly as a result of the legislative reaction in the US and elsewhere to the Enron and other scandals, a revised Directive was approved in 2006. *Inter alia*, the revised Eighth Directive requires member states to establish auditor oversight bodies; sets out rules on professional ethics and independence; requires the use in statutory audits of international auditing standards (ISAs) endorsed by the EU; requires the establishment of audit committees by public interest entities; and the publication of transparency reports on audit firms. The Directive is discussed further in Chapters 19 and 20.

Financial services Directives have been adopted on, *inter alia*, transparency in EU capital markets (2004, revised in 2013) and cross-border takeovers (2005). These largely relate to listed groups, so are not directly relevant to this chapter.

13.2.6 Research findings

Several of the empirical studies referred to in Chapter 4 applied their proposed measures of harmonization to European differences. Little harmony or harmonization was discovered within the EU. A further empirical paper on Britain and France after EU harmonization by Walton (1992) found little evidence of harmony in a case study concerning several accounting measurement issues. Parker (1996) examined the *de jure* harmonization of the notes to financial statements between Britain and France. He found that the notes still had a different status in the two countries, but that French notes had expanded towards the coverage of British notes.

13.3 Transition in Central and Eastern Europe

13.3.1 Introduction

It became clear in the late 1980s that the command economies of Central and Eastern Europe were failing to deliver economic growth. The inability of communist parties to hold on to political power led to the overthrow of governments (once the threat of Soviet armed intervention was lifted), the reunification of West and East Germany and the break-up of the Soviet Union itself. This section looks collectively at financial reporting in the large number of European countries formerly under Soviet domination. They include those that were constituent parts of the Soviet Union (Russia, Ukraine, Belarus, Moldova and the Baltic states of Estonia, Latvia and Lithuania) as well as Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Albania, Serbia, Croatia, Bosnia, Slovenia and Macedonia. As already noted, 11 of these countries became members of the EU in 2004, 2007 or 2013. On accession all had GDPs per head below the average of the 'EU of 15'. As members they were committed to

enacting legislation implementing the accounting Directives and requiring their listed companies to comply with international financial reporting standards in their consolidated financial statements. Other European countries, even those not aspiring to join the EU (notably Russia) have been influenced by the EU.

Financial reporting cannot, however, be reformed simply by the adoption of EU laws, which in any case, as we have seen, are themselves by no means fully harmonized. This section can be read as a case study on the difficulties of transition. Many of its points would therefore apply in other continents.

Enterprises in emerging market economies, which previously relied on government finance, needed access to non-governmental sources of finance, both debt and equity. Debt, especially bank loans, was generally a more important new source than equity (especially given the lack of personal savings where there had been high inflation). This made it relevant to have accounting rules biased towards creditor protection. However, it was useful for larger companies to have a financial reporting system based on Anglo-Saxon concepts in order to attract foreign investment. Also, the international agencies such as the World Bank, which provide some of the funds for these economies, generally require accounting information in a recognized international format and certified by a recognized international audit firm. Although 'capitalist' accounting (whether of the Anglo-Saxon or continental European variety) was not *imposed*, it is still, to varying degrees, a foreign implant that requires adaptation to local circumstances.

Events since the break-up of the Soviet Union and its loss of control over Central and Eastern Europe amply demonstrated that the region is no less diverse politically, economically and culturally than Western Europe. This diversity manifests itself in financial reporting just as it does in other areas. It is neither possible nor profitable to look at every country in detail, especially as the detail of laws and regulations has been, and still is, subject to rapid change. The former German Democratic Republic is a special case. Its business enterprises have to comply with the accounting rules established by the German Federal Republic (see Chapter 15). The economic stresses of reunification, however, as discussed elsewhere in this book, led to changes in financial reporting by major German companies (Young, 1999).

The development of financial reporting in Eastern and Central Europe was inevitably subject to more discontinuities than in countries such as the United Kingdom and the United States, but no country has broken completely with the past, and influences remain both from the pre-communist period and from the communist period.

13.3.2 Pre-communist accounting

Accounting in pre-communist Eastern and Central Europe (which excludes those countries that were part of the Soviet Union between the two World Wars) had, as was the case also in Austria (Nowotny and Gruber, 1995), many similarities with that in Germany. In the absence of sophisticated equity capital markets, there was an emphasis on creditor protection and tax collection, and a preference for national charts of accounts, mainly based on the pioneering work of Schmalenbach in Germany in the 1920s. Schmalenbach's chart was intended for a market economy but could be adapted to a planned economy, as happened in Nazi Germany in the 1930s and Vichy France in the early 1940s (see Chapter 14), and to a command economy,

as in the Soviet Union in the 1920s. Many occupied countries in Eastern and Central Europe were forced to adopt the German chart during the Second World War, and then the Soviet chart after the War (Richard, 1995a). Business transactions were regulated by means of commercial codes based on the German model, which in its turn was based on the French Napoleonic Code.

In Poland, for example, during the inter-war period, economic development was slow and characterized by governmental intervention. Industrial finance was dominated by the banks, both state-owned and private. Relevant legislation on accounting, audit and companies was consolidated in the Commercial Code of 1934, which was influenced by the German code. The Accountants Association in Poland (AAP) was established in 1907, but its influence on accounting regulation was slight and the accountancy profession was weak and fragmented. There was no national chart of accounts. Such improvements in accounting practice as there were in the 1930s were mainly the result of pressure from the tax authorities. During the German occupation (1939–44) the rules of the uniform German General Plan of Accounts were in force.

13.3.3 Communist accounting in a command economy

For many decades the accounting practices in the communist countries of Central and Eastern Europe were very distinct from, and largely cut off from, those in Western Europe, although accounting in countries such as Hungary and Poland had, even before 1989, become more adaptive and flexible as a result of economic reform and democratization (Bailey, 1988). This distinctiveness was inevitable in the absence of privately owned enterprises and market-determined prices. The main objective of accounting systems under the command economy of traditional communism had been the provision of financial statistics (often in terms of quantities rather than values) for use in higher-level budgets. There was very little emphasis on accountability, which is a crucial element in accounting in a market-based economy in which managers are delegated with the control of resources by the shareholders of companies who are granted limited liability in order to encourage investment. There was no concept of 'fair presentation' or 'true and fair view' in a command economy. Financial reporting was thus 'hierarchical' rather than 'lateral', so that reports flowed upwards through the administrative structure rather than outwards into the market.

Accounting in a command economy was of relatively low status, was inflexible and did not have to respond to market innovations. For example, the Soviet accounting system used throughout Eastern Europe was largely a matter of clerical bookkeeping and was compulsory for all state enterprises. Soviet-style national charts of accounts were imposed. It was because accounting had become ever more standardized, simplified and routinized that it regressed to bookkeeping. Accounting records were much more important than financial statements.

The nature of accounting in a command economy had important consequences that impeded the transition to post-communist accounting. Under communism, a sophisticated accountancy and auditing profession had not developed. The accounting worker tended to be, in the words of Bailey (1988, page 12), 'the personification of the conservative and rule-bound bureaucrat'. In Hungary, for example, accountants were regarded as low-skilled technicians during the communist period.

Consequently, the profession lost its reputation, and was not able to attract young people of talent (Borda, 2001, page 1536).

In Poland, during the period of communist rule and a centrally planned economy (1944–89), accounting lessened in importance, comprising essentially a very detailed set of financial rules based on a Soviet-style national chart of accounts, although this chart was modified from time to time. There was no independent accountancy profession and no scope for innovation in accounting practice. Accounting became an instrument of central economic administration exercised through a uniform accounting system mandatory for all enterprises.

13.3.4 Problems of transition to a market economy

In a command economy the means of production are in public ownership, the state dominates the economy, and economic activity is supposed to respond to state direction. By contrast, in a market economy the means of production are mainly in private ownership, the state creates the legal framework in which economic activity takes place, and economic activity is supposed to respond to market forces. After the collapse of communist domination, the countries of Central and Eastern Europe embarked upon the ideological and practical transition from one type of economy to the other. Such a transition obviously has important consequences for accounting, which ceases to be an instrument of state economic administration and becomes instead an instrument at the disposal of the business community (Bailey, 1995).

Progress in making the transition varied greatly from country to country. Annual macroeconomic assessments are available in the *Transition Reports* of the European Bank for Reconstruction and Development. Summing up success under the six headings of structural reform, control of inflation, privatization, economic growth, limitation of corruption (perhaps the one most related to accounting and auditing) and democracy, Aslund (2002) awarded a full score of six only to Estonia and Hungary. These were the only two with a corruption score better than the worst West European countries on the Transparency International Index.

In the transition from a command to a market economy, there was a serious shortage of skilled accountants and auditors. The profession had difficulty in acting as a source of improved practices and regulations, so that this function had, paradoxically, to be performed by discredited state authorities. Ministries of Finance acquired a dominant position in post-reform accounting regulation, reflecting not only their roles in state-directed economic planning and as tax assessors and collectors, but also, in many countries, the need to legislate accounting reforms consistent with EU Directives. This dominance of Ministries is also to be found in creditor/tax countries such as France, Germany and Japan (see Chapter 2).

In making the transition, each country was able to make use not only of its own experience of pre-communist and communist accounting but also of the rules and practices of the outside world, in particular those of the EU (which many of the countries have joined or aspire to join) and its member states, and of the International Accounting Standards Board. This richness of outside examples (which may have come as a surprise to East European accountants) did not make the transition any easier, given the diversity of practice within the EU (even after the adoption of IFRSs

by listed companies in their consolidated financial statements) and the fact that international standards are philosophically of Anglo-Saxon rather than of continental European origin.

For example, a compulsory national chart of accounts has been retained in Russia, and also in other members of the former Soviet bloc, e.g. Romania. However, Russia and Romania have reformed them in different ways. Russia adapted the old Soviet model to a market economy but retained a chart originally inherited from Schmalenbach's *Kontenrahmen* based on the processes of production rather than, as in France, on the financial statements. Romania, on the other hand, abandoned the old-style Soviet chart for one based closely on the French model. Richard (1995b) argues that the reasons for these differences are political rather than technical. Romanian accountants, unlike Russian accountants, regard the Soviet chart as a foreign import; some Romanian accountants were interested in strengthening their influence with French help; French accountants wanted to strengthen French economic interests in Romania; and a French-style chart is seen in Russia as moving away rather than towards US practices. Russian law, unlike Romanian law, has not been influenced by the French *droit comptable*. However, a project began in 1996, sponsored by the British Foreign Office, designed to help Romanian accounting to evolve in a direction closer to the capital-market style of accounting found in the Anglo-Saxon world. King *et al*. (2001) provide an inside view of how the project proceeded and why IASs were considered appropriate. In 1999 a Ministerial Order was published which enshrined both the IASC's framework and the body of the IASC's standards into Romanian legislation. Roberts (2001) examines this and notes what he considers to be a range of conflicts and confusions caused by mixing a French-based philosophy with IASC content.

Both domestic pre-communist and external non-communist sources have advantages and disadvantages. Pre-communist practices and regulations may have been tailored to the country concerned but are likely to be very outdated. Practices from outside may be much more up to date but may be of unnecessary complexity and sophistication and may be an 'inappropriate technology'. As mentioned in Section 13.2 for Western Europe, there were of course also translation problems in Eastern Europe. Albu *et al*. (2013) discuss the difficulties of translating 'true and fair view' in Romania, noting that there was more of a problem with the concept than with the signifiers.

Not surprisingly, most of the new laws retain some aspects of the old ones, especially given the lack of qualified accountants and the importance of accounting for tax collection. The latter is particularly relevant in those countries that lack capital markets on which the state can raise loans. This means both a relatively great emphasis on accounting record keeping and on charts of accounts and also, as in Germany, an extension of accounting regulation to all types of business enterprises, not just limited liability companies.

In practice, both historical and external sources were drawn upon. There was a widespread reintroduction of pre-Second World War corporate laws and commercial codes. These were originally German-based and are compatible with the EU Directives that, as new and aspirant member states, many former communist countries introduced into their legislation. However, the influence of the IASC/IASB and the Big-4 international accountancy firms (all of which expanded vigorously into the

region: Kirsch *et al*., 2000) brought in more Anglo-Saxon ideas of accounting. This is not necessarily inappropriate because these countries, unlike Germany until recently, do not have the strength of their economies to shield their few large companies from the demands of the international capital market. Furthermore, many foreign investors preferred to base their decisions on non-statutory financial statements reworked by an international firm rather than on statutory statements (Bailey and Alexander, 2001a). Independent corporate audit was a new concept in Eastern Europe and the Big-4 audit firms successfully sought to obtain the audits of the largest domestic companies. The demand for local accountants trained in Anglo-Saxon accounting skills has been partly met by making the British-based ACCA qualification available to them and by the translation of teaching materials into local languages (Sucher and Zelenka, 1998, pages 730–1; Focus, 2000).

External auditing and auditor independence are not needed in a command economy and cannot, for many reasons, be established quickly in practice in a transition economy even if relevant legislation and regulations are enacted (Sucher and Kosmala-MacLullich, 2004a, 2004b). Chambers of Auditors have been set up but tend to be staffed in the first instance by accountants brought up and trained in the culture and procedures of a command rather than of a market economy. Furthermore, independence may be threatened by competition among auditors for clients, by a legal system that penalizes departures from tax rules rather than provides protection for investors, and by client companies vulnerable to collapse if they receive a qualified audit report. Audit failure has received much publicity in some countries (e.g. the Czech Republic). The Czechs have contributed the word 'tunnelling' to the international accounting vocabulary to describe the transfer (as through an underground tunnel) of assets and profits out of companies for the benefit of the managers who control them (Johnson *et al*., 2000).

Baker *et al.* (2015) look back over the 25 years since the fall of communist regimes. They summarize the research into accounting change in post-communist economies.

13.3.5 The example of Poland

Different ex-communist countries have made different choices, which have been influenced by political as well as technical factors. In this sub-section, we concentrate on the example of Poland, which is the largest former communist country to have joined the EU. In Poland, legislation was passed between 1989 and 1991 reorganizing the banking and insurance sectors, starting the process of privatization, and creating a stock exchange in Warsaw. Legislation on bankruptcy dating from the inter-war period was revived. Personal and corporate income tax Acts were passed in 1991 and 1992. The 1934 Commercial Code was revived with the start of privatization. Privatization of state enterprises proceeded slowly, partly because of the rigorous criteria imposed by the Securities Commission that was set up in 1991 (on the model of the US Securities and Exchange Commission) to regulate the stock market. A 'mass privatization' law was passed in 1994, under which some 500 medium-sized companies were allocated to 15 National Investment Funds (NIFs) set up by the state. The NIFs are the main owners of the companies. All adult Polish citizens were entitled to a 'universal' share certificate exchangeable into NIF shares (OECD, 1996, Annex IV). Transfer of ownership also took place by other means, but the residual state sector remains

relatively large (OECD, 2000, page 20 and Annex V). The Warsaw Stock Exchange had about 470 domestic listed companies in 2015, most of which are audited by international accounting firms.

An Accounting Decree was issued by the Ministry of Finance in January 1991 to cover all enterprises except financial institutions. It was heavily criticized (Jaruga, 1993) both as lacking the prestige of accompanying legislation and as insisting on an unhelpful uniformity and was superseded by the Accounting Act of 1994, which was itself significantly amended in 2000 (Reczek and Lachowski, 2002).

The Act, which took account of the Seventh EU Directive, as well as the Fourth, requires the presentation of a 'true and fair view', which means that the accounting rules formally (but not necessarily in practice) override the tax requirements. The true and fair view requirement is perceived in practice as compliance with legal pronouncements on financial reporting, including tax rules (Kosmala-MacLullich, 2003). The concept is treated as a formula to be complied with, without further investigation into its wording and meaning (Kosmala, 2005). In 1995 the Ministry of Finance issued a Decree specifically on consolidations.

An important innovation was the formal divorce between tax and financial reporting, with the concomitant introduction of the concept (but not yet the common practice) of deferred taxation. Deferred tax liabilities *must* be accrued; deferred tax assets *may* be accrued. Also important are the emphasis on prudence and the introduction of cash flow statements.

The 1994 Accounting Act does not impose an obligatory uniform chart of accounts but economic entities are required to draw up their own accounting plans. An optional Model Chart of Accounts was developed and published by the Accounting Association in Poland in 1995 (Jaruga and Szychta, 1997).

The shortage of well-tried and experienced staff is a major problem affecting the implementation of both auditing and accounting standards. Nevertheless, few audit failures have been reported (Sucher and Kosmala-MacLullich, 2004b). More information on auditing in Poland is given in Krzywda *et al*. (1998) and in Schroeder (1999).

Measurement rules in Poland have, since the days of the Second Republic, been strongly influenced by the detail of income tax legislation. This link was weakened by the Accounting Act of 1994 but is still important given that Polish accountants lack experience of financial reporting not driven by tax rules (Jaruga *et al*., 1996). For tax purposes, but not in principle for financial reporting purposes, depreciation rates and methods (including accelerated depreciation to encourage investment), inventory valuation methods and provisions for bad and doubtful debts are all largely determined by rules laid down by the Ministry of Finance, with little choice available to the individual company.

The Commercial Code requires the creation of a legal reserve by public companies, but contains very few disclosure requirements. This gap has been filled by the Accounting Act, which has adopted the financial statement formats of the EU Fourth Directive. The formats are reproduced in both Polish and English in Jaruga and Schroeder (2001), who also summarize the regulations in the Act relating to the form and content of published financial statements, and asset valuation and income measurement. Some of the reporting traditions of the command economy have persisted, however – for example in the definition in the Act of 'extraordinary items',

which includes, for example, bad and doubtful debts and the costs of abandoned projects (Krzywda *et al.*, 1996, page 78).

An Accounting Standards Committee was established under the Ministry of Finance with a membership representative of academia, large international and domestic auditing firms, the Securities Commission, the NCSA, the AAP and domestic banks. The Committee aims to prepare national accounting standards for implementation as revisions of and amendments to the Accounting Act.

13.3.6 The example of Russia

In Europe, accounting change has been slowest in Russia and the other successor states to the Soviet Union. Russia has a large informal ('black') economy, a high degree of corruption, weak law enforcement, little demand for the provision of financial statements to outside investors and no tradition of external auditing or of auditor independence. In practice the main role of an auditor is to ensure that there are no problems with the tax authorities, who can act at times almost as a political arm of government (Sucher and Bychkova, 2001; Sucher *et al.*, 2005). The transition to Western-style democracy and capitalism has proceeded more slowly and been accompanied by a considerable amount of economic and political chaos. In these circumstances a precipitate rate of accounting change could lead to 'accounting uniformity being displaced by accounting disarray' (Bailey and Alexander, 2001b). In Russia, unconditional adoption of the Anglo-American accounting model 'is not considered to be the best way to reform the national accounting system' (Sokolov *et al.*, 2001). Certain well-established aspects of Russian accounting, both communist and pre-communist, are likely to persist: a strong emphasis on the control function of accounting; adherence to a national chart of accounts; detailed regulations and instructions from central state authorities such as the Ministry of Finance; and a relatively weak accountancy profession (Enthoven *et al.*, 1998).

One of the biggest stumbling blocks to reforming accounting in transitional economies was the close link between financial reporting and fiscal reporting. One of the largest changes in Russia was the amendment of tax legislation and the implementation of Chapter 25 of the Tax Code. This effectively separates financial and tax reporting. Separate accounts have to be kept for tax reporting from those for financial reporting. While this may seem to be a positive development, which should enable Russian financial reporting fully to embrace an approach based on IFRS (see 13.3.7), there was concern about what will actually happen on the ground. It is possible that compliance with two sets of rules will be too complex and expensive for most Russian companies. Many companies may comply only with the taxation reporting rules (Krylova, 2003b). This is more likely to be so for private companies, for whom reporting to the taxation authorities and minimizing tax payments is the dominant reason for the preparation of financial statements, than for public companies. The latter have greater incentives to improve the quality of their reported earnings in order to attract outside investors. Goncharov and Zimmermann (2006) provide empirical evidence that, in Russia as elsewhere, compliance with tax rules has a greater effect on financial reporting by private companies than by public companies.

13.3.7 Applying IFRS

In anticipation of joining the EU, most of the Central and Eastern European countries sought to implement accounting legislation that brought them into line with EU Directives and Regulations. After the initial implementation of new accounting legislation from 1989 onwards, they further updated their accounting legislation to bring it more into line with IFRS. Examples are the amendments to the Accounting Act in 2001 and 2003 and related Accounting Decrees in the Czech Republic (Sucher and Alexander, 2002; Sucher and Jindrichovska, 2004) and the Amendment to the Accounting Act 2000 in Poland (Kosmala-MacLullich, 2003; Vellam, 2004). The 2002 Regulation of the EU on the application of IFRS requires listed companies to prepare IFRS consolidated financial statements. Use in other financial statements is optional. As in Western Europe, the response to the Regulation in the transitional economies has been varied and complex. As shown in Table 12.3, the Czech Republic requires IFRS in the individual statements of listed companies, but bans them from the individual statements of unlisted companies. By contrast, Poland permits, but does not require, IFRS for the statements of subsidiaries of listed companies, whereas Hungary (similarly to France) bans them from all but the consolidated statements of listed companies. The three Baltic states (similarly to Cyprus) require IFRS for all financial statements, perhaps because they are small economies lacking their own well-developed national rules. There are considerable differences between IFRS and national accounting regulations (for Poland see Krzywda and Schroeder, 2007).

Although Russia is not a member of the EU, many large Russian enterprises, mainly in response to the demands of overseas funds providers, prepared financial statements allegedly based on international standards by the late 1990s, and new regulations were enacted to bring Russian accounting rules closer to IFRS (Enthoven *et al.*, 2001; Krylova, 2003a). In practice these statements were often drawn up by the companies' auditors, and in particular by offices of the Big-4 accountancy firms. Sucher and Alexander (2004) suggested that compliance with international standards was often incomplete and that training in the use of IFRS was badly needed. From 2004, the consolidated financial statements of banks had to be prepared according to IFRS. This was extended to other listed companies for 2012 onwards. Kim (2013) finds that the value relevance of accounting information increased (compared to that under Russian standards) for those Russian companies using IFRS before 2012 because they were listed on the London Stock Exchange. Nevertheless, accounting for most enterprises is still in practice dominated by the uniform chart of accounts (significantly revised as from 1 January 2001).

Implementation and enforcement of IFRS in transition economies was not easy. For example, the problems in the Czech Republic are discussed in Sucher and Alexander (2002) and Sucher and Jindrichovska (2004). The implementation process was dominated by the Ministry of Finance and the needs of the tax inspectorate. The directors of larger listed Czech companies often rely heavily on international accounting firms to prepare their IFRS financial statements, may themselves have little understanding of them and in particular find the concept of substance over form alien. Smaller listed Czech companies, owned by local investors and audited by local firms, had more difficulty in moving to IFRS and the benefits of them doing so are less obvious. These findings probably apply to other transitional economies as well (for Poland see Jaruga *et al.*, 2007).

More recently, Eastern European countries have been considering whether to adopt IFRS for SMEs. However, at the time of writing, such countries are conspicuously absent from the list of 70 countries where IFRS for SMEs is required or allowed: http://www.ifrs.org/Use-around-the-world/Pages/Analysis-of-SME-profiles.aspx (accessed on 23 April 2015). Strouhal (2011) examines accounting by SMEs in Central and Eastern Europe.

SUMMARY

- The world's most powerful source of change towards regional harmonization has been the EU. Harmonization of accounting is one of the many aims of its Commission as part of the overall objective to remove economic barriers within the EU.
- Harmonization was achieved through EU Directives and Regulations. The Fourth Directive caused some change in most EU countries in formats of accounts or disclosure or valuation procedures. The Seventh Directive achieved a significant degree of harmonization of group accounting. The Directives were combined and re-arranged in 2013.
- Financial reporting in Central and Eastern Europe has been transformed as a result of political change and economic reforms.
- The former communist countries of Europe are very diverse and their financial reporting rules and practices reflect this. Many adopted continental European accounting, including charts of accounts and the predominance of tax rules, but Anglo-Saxon accounting has also been influential. Accounting – and the accountancy profession – is gaining in status and influence compared with the period of communist rule.
- Eleven Central and Eastern European countries joined the EU from 2004 to 2013, and the consolidated financial statements of their listed companies have to comply with IFRS. Although Russia is not a member of the EU, the same applies from 2012. In some countries, companies are required or permitted to also apply IFRS to other financial statements.

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Useful websites

European Accounting Association	www.eaa-online.org
European Commission, Internal Market	ec.europa.eu.int/internal_market
Fédération des Experts Comptables Européens (FEE)	www.fee.be
IAS Plus	www.iasplus.com
Organisation for Economic Co-operation and Development	www.oecd.org
Warsaw Stock Exchange	www.wse.com.pl
World Bank, Reports on the Observance of Standards & Codes. Accounting & Auditing	www.worldbank.org/ifa/rosc_aa.html

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

13.1* Is it both *desirable* and *possible* to harmonize company financial reporting in the European Union?

13.2* In what ways have pre-communist and communist accounting affected post-communist accounting in Central and Eastern Europe?

13.3 What effect, if any, has harmonization in the EU had on *non-member* states in Europe?

13.4 Discuss the choice of national charts of accounts in post-communist Russia and Romania.

13.5 Compare the importance of the influences of Anglo-Saxon accounting and continental European accounting in Eastern Europe during the 1990s.

13.6 Why is auditor independence a problem in Central and Eastern Europe?

13.7 Why, and to what extent, has post-communist Romania adopted Anglo-Saxon rather than French-style corporate financial reporting?

13.8 Which was more successful at harmonization until 2001: the IASC or the European Union?

13.9 Compare the importance of the influences of Anglo-Saxon accounting and continental European accounting in Eastern Europe and China in the 1990s.

14 Making accounting rules for unlisted business enterprises in Europe

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OBJECTIVES

After reading this chapter, you should be able to:

- explain who makes the accounting rules for unlisted business enterprises in France, Germany and the UK;
- explain why the forms of business enterprise subject to accounting rules differ from country to country within the European Union;
- describe the legal forms of business enterprise in France, Germany and the UK.

14.1 Introduction

Chapter 12 explained that, under an EU Regulation, IFRS apply compulsorily only to the consolidated financial statements of listed companies, although some member states have extended their application. The present chapter and Chapter 15 are concerned with the overwhelming majority of business enterprises in Europe which

are not listed and whose accounting and financial reporting rules are *not* made by the IASB or contained in US GAAP. In most of the EU, this even includes the parent (unconsolidated) statements of listed companies.

Chapter 15 looks at accounting rules and practices for individual companies. The present chapter addresses two related questions:

1. Who makes accounting rules for business enterprises not listed on a stock exchange (Section 14.2)?
2. Which business enterprises are subject to these accounting rules (Section 14.3)?

The answers to these questions differ quite considerably from country to country, in ways that, not surprisingly, are connected to the two legal systems of common law and codified Roman law distinguished in Chapter 2 and to sources of finance. The US and Japanese regulatory frameworks discussed in Chapters 8 and 11 provide instructive examples of the effect on financial reporting rules and practices of legal and financing systems.

In the present chapter, we look in detail at the current position in France, Germany and the UK. There are good reasons for choosing these three countries. They comprise the EU's largest economies and stock markets. After the US, China and Japan (studied earlier in this book), they have the world's next biggest economies. These countries have influenced law and practice elsewhere in the EU and around the world. All continue to reveal interesting differences in approaches to accounting. All, not just the two continental European countries but also the UK, have regulatory frameworks strikingly different from that in the US.

Chapters 14 and 15 do not deal with consolidated statements. Many unlisted groups still use national rules for consolidated statements. There are many interesting features of consolidation rules in the three countries of this chapter, some of which are discussed in Chapter 16. France is unique in having a different set of national rules for consolidated as opposed to unconsolidated reporting. For example, LIFO and the capitalization of leases are allowed in French GAAP for consolidated statements but not for unconsolidated statements.

14.2 Who makes the accounting rules?

14.2.1 Introduction

The diversity of accounting rule-making bodies within the EU has decreased in recent decades. Indeed, superficial comparisons suggest that few differences now remain. Compare, for example, France and the UK. As member states of the EU, they have both implemented its accounting Directives by domestic legislation (see Chapter 13). Both have Companies Acts and secondary legislation. Both have mixed public-sector/private-sector regulatory and standard-setting bodies. It might be argued that the only difference of importance is the lack of a national accounting plan (*plan comptable général*) in the UK. When we look more closely, however, the similarities are not as great as they appear. This will become clearer below where we look at the rule-making bodies in France, Germany and the UK in some detail.

14.2.2 France

The state has been a major influence on French accounting since at least the late seventeenth century, although often in indirect and complex ways. Colbert's *Ordonnance de Commerce* of 1673 during the reign of Louis XIV formed the basis for the Napoleonic Commercial Code (*Code de Commerce*) of 1807 (Howard, 1932). The Code spread throughout continental Europe and beyond (e.g. to China and Japan, see Chapter 11). The influence of the state was especially strong from 1946 to 1983 but it has since weakened under the impact of external factors such as the company law harmonization programme of the EU and the impact of increasingly global capital markets dominated by Anglo-Saxon countries and in particular by the United States. Nevertheless, the influence of tax on accounting remains strong, as noted later in this sub-section.

Colasse and Standish (1998) distinguish four periods of development since World War II, and we add two more here:

1 1946–57: a period of post-war reconstruction and indicative planning of the economy by the French state, during which the national accounting plan (*Plan comptable général,* PCG) was established, with mainly macroeconomic aims and little input from the accountancy profession; the PCG was created and maintained by a state body called the *Conseil National de la Comptabilité* (CNC) whose predecessor body had been founded in 1946.

2 1958–73: a period of modernization and strong economic growth, during which the field of application of the PCG was extended and more closely linked to tax rules.

3 1974–83: a period of economic instability and the high point of *normalisation à la française* (accounting standardization, French style), during which the EU company law Directives were integrated into French accounting and the formal regulation of French accounting greatly increased.

4 1984–97: a period of globalization, deregulation and privatization, during which the French approach was put severely to the test, accounting institutions were reorganized, the role of the accountancy profession was strengthened, and international standards emerged as a strong competitor to national standards.

5 1998–2009: a period of reforming accounting rules, with the creation of the *Comité de la Réglementation Comptable*; a new accounting plan and more 'international' consolidation rules in 1999; and the arrival of IFRS for the consolidated statements of listed companies (and optionally for those of other companies).

6 2010–: a period in which the CNC and CRC have been replaced by the *Autorité des Normes Comptables* and in which France has grown accustomed to IFRS.

The net result of all these influences has been to produce a dualism in French accounting between the financial statements of individual business enterprises and those of groups. Group accounting has had special rules since it became compulsory in 1987, so French accountants were already prepared for the idea that IFRS would apply only to consolidated statements.

The increase in the volume of French rules on accounting has led to the recognition of a *droit comptable* (a body of legal rules relating to accounting). These rules originate from a variety of sources. Those relevant to the financial statements of individual companies were classified as follows by Raybaud-Turrillo and Teller (1998):

- *Public sources*:
  - French state – laws (*lois*), decrees (*décrets*), ministerial orders (*arrêtés*), national accounting plan;
  - EU – Directives (implemented by domestic legislation) and Regulations.
- *Mixed public/private sources*:
  - national accounting council (*Conseil National de la Comptabilité*, CNC);
  - accounting regulation committee (*Comité de la Réglementation Comptable*, CRC).

We adopt this classification in the discussion below, although both the CNC and the CRC were replaced by the *Autorité des Normes Comptables* (ANC) in 2009. Hoarau (2009) examines the creation of the ANC. He shows that the number of members (and bodies represented by the members) has been reduced over time, as has the role of the state. We also explain below the roles of the accountancy and auditing bodies, the *Ordre des Experts Comptables* (OEC) and the *Compagnie Nationale des Commissaires aux Comptes* (CNCC). The work of the stock market regulator, the *Autorité des Marchés Financiers* (AMF) (see Chapter 20), does not directly concern individual financial statements.

The most distinctive part of French accounting regulation is the national accounting plan (*Plan comptable général, PCG*). The plan is administered by the ANC (formerly by the CRC on recommendations from the CNC). The PCG is not merely a chart or classified list of ledger accounts but a very detailed manual on internal accounting and external reporting. Included within it are definitions of accounting terms, valuation and measurement rules and model financial statements. Many accounting textbooks are based on it. All French accountants have been trained to use it, for recording accounting transactions, for drawing up financial statements and for filling in tax returns. Standish (1997, pages 273–6) suggests that the PCG has in effect created a national accounting language and that in this area the CNC played a comparable role to that of the *Académie Française* for language in general.

Various aspects of the history of the plan are discussed by Standish (1990), Fortin (1991) and Richard (1992). The version of the plan promulgated in 1947 owed as much to German as to French ideas. The plan was revised in 1957 and again in 1982 and 1986 to take account of the Fourth and Seventh Directives of the EU (see Chapter 13). Importantly, the 1982 plan, unlike previous plans, was made compulsory for all industrial and commercial companies. Another version of the plan was issued in 1999, and the most recent one in 2014. Changes are made from time to time to incorporate new rulings on, for example, such matters as long-term contracts. In particular, amendments are being made in order to bring French rules closer to those of IFRS (but see Section 15.2.2). Unlike the 1982 version, the 1999 and 2014 plans exclude any reference to cost and management accounting and to consolidated financial statements. In other respects they mainly re-arrange the 1982 plan.

The basis of the plan is a decimalized chart of accounts. The major account classes are:

Balance sheet accounts

1 Capital (owner equity, loans and debts payable)

2 Fixed assets

3 Stocks and work in progress

4 Debts receivable and payable

5 Financial

Operating accounts

6 Charges

7 Income

There is further subdivision. For example: 21 Tangible assets; 211 Land; 2115 Land with buildings on it; 21155 Land with administrative buildings on it.

Appendix 14.1 lists the contents of the 2014 plan; Appendix 14.2 sets out the chart of accounts contained within the plan. It will be noted from Appendix 14.2 that the classification of expenses and revenues is by nature not by function (see Chapter 2). This has disadvantages for some users of income statements but enables the PCG to be applied the same way by all business enterprises. Certain industrial sectors have their own adaptations of the PCG, the so-called *Plans Professionnels*.

Tax law plays an important role in the individual financial statements of French companies and other business enterprises for two reasons: the rules for measuring reported accounting profit in such statements do not differ significantly from those for measuring taxable income; and expenses are generally only deductible for tax purposes if treated as expenses in the annual financial statements. The legislator has been concerned, at the level of the individual enterprise, to harmonize accounting and tax law and this has been largely achieved by formalizing a connection between the Tax Code (*Code général des impôts,* CGI) and the PCG. The Commercial Code and the Companies Act are also compatible with the PCG although they do not refer to it. However, in recent years the influence of tax rules has been under attack. Lamb *et al.* (1998) looked in detail at the links between accounting and taxation in France. Although many of the rules have changed since that date, the basic conclusion, that unconsolidated reporting in France is strongly influenced by tax considerations, remains true.

Professional accountancy developed later in France than in the UK or the US. The Big-4 firms are well established in France but none of them is of French origin. The *Ordre des Experts Comptables* (OEC) was established in 1942 and reconstituted by the post-war government in 1945. Although growing in size and influence, it is a smaller, weaker and less autonomous body than, say, the ICAEW in the UK and has never been responsible for setting accounting standards. However, as already noted, it participates in the work of the ANC. It issues opinions (*avis*) on accounting matters. The functions of the *Compagnie Nationale des Commissaires aux Comptes* (CNCC) and the *Haut Conseil du Commissariat aux Comptes* (H3C) are discussed in Chapter 20.

14.2.3 Germany

Most German rules on accounting for individual enterprises are made by the German state and are set out in the *Handelsgesetzbuch* (HGB, Commercial Code) and in tax legislation. The HGB requires that the annual financial statements be prepared according to the principles of orderly bookkeeping (*Grundsätze ordnungsmässiger Buchführung*). To the extent that these principles are not set out in the Code, they must be deduced from it, from statements by the *Institut der Wirtschaftsprüfer* (see below) and from tax legislation, as well as from published Commentaries by distinguished professors and others, and the accounting practices of enterprises.

The HGB dates from the nineteenth century, but has been amended by laws from time to time. The Fourth Directive (and the Seventh) was implemented in Germany as the *Bilanzrichtliniengestz* of 1985. As the Directive had been based on German law (see Chapter 13), this meant that little change to the HGB was necessary when implementing the Directive. German legislators decided to make as few changes as possible, partly so as not to affect taxable income. McLeay *et al.* (2000) study the process of lobbying within Germany, suggesting that companies had the greatest influence on the content of the revisions.

Tax law and Federal Fiscal Court decisions are in practice also major sources of accounting rules. The so-called 'authoritative principle' or conformity principle (*Massgeblichkeitsprinzip*) applies to the determination of taxable income. This principle states that tax statements are based on the commercial statements (Haller, 1992). Until the *Bilanzrechtsmodernisierungsgesetz* (BilMoG, Accounting Law Modernization Act) of 2009, any and all expenses that were to be tax deductible therefore had to be charged in the income statement. This included special depreciation, impairments and provisions. In practice, then, accounting numbers were often chosen with the tax effect in mind. In the case of special depreciation, tax law required it to be recorded in the commercial statements even if this obscured the insight into the company's affairs. In effect, there was a reversal of the authoritative principle, such that commercial statements were based on tax rules and motivations. In effect, the Federal Fiscal Court was the highest authority on accounting practices.

Lamb *et al*. (1998) examined in detail the closeness of the tax and accounting links in Germany, compared with the position in the United States, the United Kingdom and France. Many examples of tax influence on German accounting were given in Section 2.5. Fiscal authorities in Germany remain in general opposed to allowing accounting rules over which they have no influence to affect financial statements that form the basis for tax computations. However, changes in German tax law, especially in the area of provisions, have led to more extensive differences between financial and tax accounts. The BilMoG of 2009 brought German accounting rules closer to IFRS, although a number of differences remain. The BilMoG is designed to make the HGB a simpler alternative to IFRS, especially for smaller firms. It outlaws tax-induced accounting treatments, e.g. excessive impairments. Nevertheless, ordinary depreciation expenses, for example, may well continue to be based on what is allowable for tax, assuming that this is not out of line with commercial substance. Gee *et al*. (2010) examine the scope for influence of tax on German financial reporting. Although they largely look at IFRS reporting, they also conclude that the tax influence on unconsolidated reporting was not eliminated by the BilMoG.

The influence of the auditing profession has grown in recent years, but it is still weak. The German body, the *Institut der Wirtschaftsprüfer in Deutschland e.V.* (IdW), was formed in 1931 following the provisions of the Companies Act 1931. It is smaller than the UK and French bodies and membership is voluntary, although a large majority of German *Wirtschaftsprüfer* (WPs) have joined the Institute. Membership in the *Wirtschaftsprüferkammer* (Chamber of Accountants), which was introduced by the law regulating the accountancy profession (*Wirtschaftsprüferordnung*) of 1961, is a legal requirement. The influence of the German Institute is mainly by recommendations and releases which are binding on auditors, and by consultation in the process of law-making. Authorities such as the Stock Exchange and trade unions, which exercise direct influence in some other countries, are of less importance to accounting in Germany, but they take part in discussions on the setting of rules. This is also true of accounting academics – although there is a long tradition and great variety of approaches offered by German accounting theory. The German Accounting Standards Committee (GASC – in German, the *Deutsches Rechnungslegungs Standards Committee* (DRSC)) was set up in 1998 to develop standards for consolidated financial statements, not for individual company financial statements.

14.2.4 The United Kingdom

Company legislation is the main means by which UK governments have made rules on financial reporting. Incorporation of companies by registration, rather than by the more cumbersome means of a royal charter or a private Act of Parliament, first became possible in the United Kingdom in 1844 and was coupled with the availability of limited liability in 1855. Companies Acts apply to England, Wales and Scotland and, by a separate ordinance, to Northern Ireland. During the twentieth century, the rules greatly increased in quantity and complexity. A notable landmark was the Companies Act 1947 (consolidated as the 1948 Act), which made group financial statements compulsory, distinguished between 'reserves' and 'provisions' (thus making the creation of secret reserves more difficult), introduced many new disclosure requirements and required directors to prepare (and auditors to report on) financial statements that give a 'true and fair view'. The Act was based on the 1945 Report of the Cohen Committee on company law amendment. The accounting and audit contents of both the Report and the Act were strongly influenced by the 'Recommendations on Accounting Principles' of the Institute of Chartered Accountants in England and Wales (ICAEW), which had been issued from 1942.

The 1948 Act remained the principal Act for almost 40 years but it was amended by a series of Acts: the first in 1967, which made the disclosure of turnover (i.e. sales) mandatory, greatly expanded the information to be provided in the Directors' Report and Notes and removed the privilege of non-disclosure for family-owned private companies; another in 1976, which tightened the legal requirements for the maintenance and publication of information, strengthened the power of auditors, and increased the disclosure of directors' interests; an Act in 1980, which implemented the EU Second Directive; and one in 1981, which implemented the EU Fourth Directive. In 1985 all these Acts were consolidated into the Companies Act 1985, a 'jumbo' Act of 747 sections and 25 schedules. The accounting and auditing provisions of the

Act were amended and restated by the Companies Act 1989, which *inter alia* implemented the EU Seventh and Eighth Directives.

Despite all these amendments, UK company law was still strongly influenced by its nineteenth-century origins and, in 1998, the Department of Trade and Industry (DTI) established a Company Law Review Steering Group (CLRSG) whose Final Report was published in 2001. The Group recommended a major reworking of the whole framework of company law. Most of the recommendations in the Report were accepted by the government, and the DTI published a White Paper, 'Modernising Company Law', in July 2002. A Companies (Audit, Investigations and Community Enterprise) Act was enacted in 2004. A new Companies Act, containing many reforms, including some implementing EU Directives (see Table 13.1), but also consolidating all previous legislation, was eventually enacted in 2006. Surpassing even the 1985 Act, the Companies Act 2006 comprises 1,300 sections and 16 schedules, and is the longest Act on the UK statute book.

The accounting requirements of the UK Acts, unlike those of the American Securities and Exchange Commission (SEC), apply to the financial statements of all British limited companies, except those few incorporated by royal charter or special Act of Parliament. Furthermore, again unlike SEC requirements, the UK Acts require individual (unconsolidated) statements not just consolidated ones. There are, however (see Section 14.3), important exemptions for small and medium-sized companies.

Apart from the state, the most important influence on the rules of financial reporting has been accountants. In 1969 the ICAEW responded to what were widely regarded as damaging examples of misleading annual reports and some sustained hostile criticism of the profession, particularly by sections of the media. In order to defuse criticism and to be seen to address these problems and to retain its moral authority, the ICAEW set up an Accounting Standards Steering Committee, later renamed the Accounting Standards Committee (ASC) and joined by the other five main professional accountancy bodies of the UK and Ireland. Membership of the ASC varied, but the committee was always relatively large (21 members at the date of its dissolution in 1990), with unpaid part-time members drawn largely, although not entirely, from the profession. At the time of its demise, there was provision for up to five members, not necessarily accountants, as representatives of users of accounts. The role of the ASC was confined to developing Statements of Standard Accounting Practice (SSAPs) with adoption and enforcement remaining the responsibility of the six professional bodies. Rutherford (2007) provides a detailed history of the ASC.

In 1988 the Report of the Dearing Committee accepted the criticism that arrangements closer to those in the United States (see Chapter 8) were preferable and, in 1990, the ASC was replaced by an Accounting Standards Board (ASB) comprising a full-time paid chairman, a full-time paid technical director and seven (then eight) part-time paid members. The ASB was supervised by a Financial Reporting Council (FRC), independent of the profession. Unlike the ASC, the ASB had power to issue accounting standards on its own authority.

The ASB's standards were termed Financial Reporting Standards (FRSs). The ASB also adopted the extant SSAPs of the ASC. These remained in force until replaced by an FRS. SSAPs and FRSs contained both disclosure rules (e.g. FRS 1 on cash flow

statements) and measurement rules (e.g. SSAP 4 on government grants). Some standards were a mixture of both sets of rules, for example FRS 22 that required both the disclosure of earnings per share (not required by the Companies Act) and laid down the rules by which it was to be calculated. Most standards applied to all large and medium-sized companies, except when IFRS are applicable (see Chapter 5). A major difference in style compared to US GAAP is that UK (and IASB) standards have less detail. This can be expressed as a contrast between 'principles-based' and 'rules-based' standards (see Section 5.4).

Until 2016, small companies were allowed to comply with only one standard: the Financial Reporting Standard for Smaller Entities (FRSSE). This standard, which was revised periodically, reduces disclosure requirements and provides a useful summary of UK standards in many areas. The relevance of the IASB's standard for SMEs is mentioned later in this section.

One main task of the ASB was to bring about the convergence of UK and International Financial Reporting Standards. Table 14.1 lists the FRSs and SSAPs extant at the end of 2014, when UK GAAP was completely revised. FRSs 12, 20–26 and 29 were close copies of IFRS. Some standards only applied to listed companies, which is why there are two standards on foreign currency (SSAP 20 and FRS 23). As a result of the Dearing Report, the position of accounting standards was strengthened. The Companies Act requires directors of public limited companies (plcs) and other large companies to disclose in their annual reports any departures from accounting standards.

In addition to the ASB, two other new bodies were set up as part of the FRC in 1990: the Financial Reporting Review Panel (FRRP) and the Urgent Issues Task Force (UITF), modelled on the EITF of the United States (see Chapter 8). The UITF was disbanded with the ASB in 2012. The FRRP monitors the quality of financial reporting and can bring legal action against companies. Its work is discussed in Chapter 20.

In 2010, the ASB issued two exposure drafts (FREDs 43 and 44) proposing to abolish the existing UK GAAP and replace it with a version of the IASB's *IFRS for SMEs* (see Section 12.5). One reason why the *IFRS for SMEs* could not be adopted without amendment is that it is inconsistent on some small matters with the Companies Act, in ways that cannot be solved by changing the law because that would require a change to the EU Directive. For example, the *IFRS for SMEs* does not allow any gains or losses to be called 'extraordinary', whereas the Directive (and therefore the Act) defined that term and shows a place for it in the profit and loss account. This particular problem has since been removed because the revised Directive of 2013 no longer includes the concept of extraordinary items.

In 2012, in the middle of all this action on replacing UK GAAP, the ASB was abolished by the Financial Reporting Council, which took direct control of accounting standards, although setting up an Accounting Council (with many members from ASB) to advise it and to prepare draft standards.

The FRC issued the following documents from 2012 to 2015:

- FRS 100 Application of Financial Reporting Requirements
- FRS 101 Reduced Disclosure Framework
- FRS 102 The Financial Reporting Standard Applicable in the UK and Republic of Ireland
- FRS 103 Insurance Contracts

Table 14.1 Old UK GAAP: SSAPs and FRSs, as at the end of 2014

SSAP	
4	Accounting for government grants
5	Accounting for value added tax
9	Stocks and long-term contracts
13	Accounting for research and development
19	Accounting for investment properties
20	Foreign currency translation
21	Accounting for leases and hire purchase contracts
25*	Segmental reporting

FRS	
1	Cash flow statements
2	Accounting for subsidiary undertakings
3	Reporting financial performance
5	Reporting the substance of transactions
6	Acquisitions and mergers
7	Fair values in acquisition accounting
8	Related party disclosures
9	Associates and joint ventures
10	Goodwill and intangible assets
11	Impairment of fixed assets and goodwill
12	Provisions, contingent liabilities and contingent assets
13	Derivatives and other nancial instruments: disclosures
15	Tangible fixed assets
16	Current tax
17	Retirement benets
18	Accounting policies
19	Deferred tax
20	(IFRS 2) Share-based payment
21	(IAS 10) Events after the balance sheet date
22*	(IAS 33) Earnings per share
23*	(IAS 21) The effects of changes in foreign exchange rates
24*	(IAS 29) Financial reporting in hyperinationary economies
25	(IAS 32) Financial instruments: disclosure and presentation
26*	(IAS 39) Financial instruments: recognition and measurement
27	Life assurance
28	Corresponding amounts
29*	(IFRS 7) Financial instruments: disclosures
30	Heritage assets

Note: *Apply particularly to listed companies.

- FRS 104 Interim Financial Reporting
- FRS 105 The Financial Reporting Standard Applicable to the Micro-entities Regime

FRS 100 explains which standards apply under which circumstances. FRS 101 is a special British version of IFRS. It differs from IFRS only in reduced disclosure requirements.

FRS 101 is designed for subsidiaries of companies which use IFRS for group reports. The replacement for old UK GAAP is FRS 102, which is the British version of *IFRS for SMEs*. In addition to solving the legal problems mentioned above, FRS 102 adds some extra options (e.g. revaluing PPE and capitalizing development costs) that were not allowed in *IFRS for SMEs*. More detail is given in Chapter 15. These new standards were available as soon as they were issued, and old UK GAAP is no longer available from 2015.

A UK company using anything other than full EU-endorsed IFRS also has to comply with the Companies Act. This means, for example, that the Act's format requirements for balance sheets apply, even though there are no format restrictions in FRS 102 itself because it is based on IAS 1.

The concept of the true and fair view has played an important role. A 'true and fair view' is nowhere defined but it is an overriding requirement. To ensure that a true and fair view is given, the Act requires additional information to be provided where necessary and, in special circumstances, the detailed provisions to be departed from (the so-called 'true and fair override'). Particulars of any such departure, the reasons for it, and its effect, must be given in the notes. It is legal counsel's opinion (Arden, 1993) that, particularly after the changes in the 1989 Act, a court would generally find that it is necessary for financial statements to comply with accounting standards in order to give a true and fair view. Counsel's opinion on the importance of the true and fair view was updated after the 2006 Act (Moore, 2008; available at: https://www.frc.org.uk/FRC-Documents/FRC/True-and-Fair-Opinion,-Moore,-21-April-2008.pdf). The opinion applies to both UK GAAP and IFRS reporting. It confirms the traditional importance of the true and fair view.

Tweedie (1988) has shown how the true and fair concept can be used both as an aid to, and as a defence against, creative accounting. Whereas the concept was once taken for granted, it has been widely debated in recent years (see Parker and Nobes, 1994; Parker, Wolnizer and Nobes, 1996; Alexander, 1999 and 2001; Nobes, 2000). The Enron affair in the US has strengthened the hand of those who prefer 'principles-based' standards.

In practice, the true and fair override has been used more by standard-setters than by companies. Unlike the IASB, the UK and other national accounting standard-setters have to set standards within the constraints of domestic law. This became more difficult in the UK with the great extension of detailed rules resulting from the implementation of EU Directives, but the ASC and the ASB were quite ingenious in using the general requirement to give a true and fair view to override particular requirements of the Act. They also, on occasion, restricted the options legally available, or effectively removed a legal option by defining it out of existence. Some illustrations are given below:

- The Act specifically permits the use of LIFO but SSAP 9 suggests that the use of LIFO will not normally lead to a true and fair view. In practice, LIFO is therefore not allowed. FRS 102 continues to ban LIFO.
- SSAP 9 was revised so that profits recognized on long-term contract work-in-progress were classified as 'amounts recoverable on contracts' rather than as part of stocks, in order to avoid the inclusion of possibly unrealized profit in the stock valuation.
- SSAP 12 (replaced by FRS 15 and now by FRS 102) was revised to remove the option, apparently permitted by the Act, of charging historical cost depreciation on revalued buildings.

- SSAP 19 required, in the interests of a true and fair view, investment properties not to be depreciated, although the Act stated (with no exception until 2004) that all fixed assets with limited useful lives should be depreciated.
- SSAP 20 (replaced for listed companies by FRS 23, and now replaced by FRS 102) used the 'true and fair view' criterion to permit gains as well as losses to be recognized on unsettled long-term monetary items, although this is a departure from prudence.
- FRS 2 (and now FRS 102) does not allow some of the permitted options in the Act relating to the exclusion of subsidiaries. The exclusion for dissimilar activities is in principle sometimes required but the standard claims that it is unlikely to occur in practice.
- FRS 3 effectively abolished the concept of extraordinary items by defining ordinary items very widely. The same words were inserted into FRS 102.
- FRS 4 (replaced by FRS 25 and now FRS 102) got around the constraint of the legal definition of shares by inventing a new category of 'non-equity shares'.
- FRS 5 required quasi-subsidiaries to be treated exactly as subsidiaries, although they are not legally subsidiaries. The law has since expanded the definition of subsidiary.
- The legal ban on offsetting assets and liabilities was escaped in certain cases by referring to them in FRS 5 as 'debit and credit balances'.
- FRS 10 allowed the possibility that goodwill should not be amortized, but this requires an override of the Act similar to that of SSAP 19. However, amortization is required by FRS 102.

Many of the above survived the convergence of UK standards with IFRS, and some of them have survived into FRS 102.

Tax law has only a minor effect on company financial reporting. It is not, as it is in many parts of continental Europe, a major determinant of the contents of and rules relating to unconsolidated financial statements. Accounting profit is not the same as taxable income, and providing for deferred taxation is standard practice. The complex relationship between tax and financial reporting is examined for the UK and some other countries by Lamb *et al*. (1998). However, the tax authorities (HM Revenue and Customs) have a policy of trying to move the calculation of taxable income nearer to the calculation of accounting net profit.

14.3 Which business enterprises are subject to accounting rules?

14.3.1 Introduction

Which business enterprises are subject to accounting rules in any particular country? There are several possibilities connected with both legal and economic criteria:

- all business enterprises;
- business enterprises with a particular legal form;

- business enterprises above a certain size;
- business enterprises whose shares are publicly traded;
- various combinations of the above criteria.

Once a jurisdiction has decided which entities to regulate, it must then decide which aspects of accounting need to be regulated. For example, the idea that all business enterprises should be required by law to keep accounting records makes good sense if the primary objectives of account-keeping are the protection of creditors and the facilitation of tax collection. The idea was expressed first in France, in the shape of Colbert's *Ordonnance de Commerce* of 1673. The requirement to keep records has obvious advantages for state authorities overseeing bankruptcy proceedings and levying taxation. In the UK, by contrast, although the needs of creditors have not been neglected, the emphasis has been more on requiring the preparation and publication of financial statements by companies whose shareholders have limited liability and where ownership may be divorced from control. The law has treated existing shareholders as the primary stakeholders and aimed to protect them as principals against directors as agents. French law has placed less emphasis on the information needs of investors. At the other extreme, the US approach since the 1930s has been to concentrate on regulating enterprises whose securities are publicly traded on a stock exchange, ignoring the needs of stakeholders in other companies.

Germany followed the French rather than the British or US approaches, but insolvencies in the 1960s of large partnerships without limited liability hit stakeholders of all kinds and led to the imposition of size criteria to determine what enterprises should disclose in their annual reports. This innovation was picked up in the EU Fourth Directive of 1978 on company law (the first draft of which in 1971 was strongly influenced by German law) and spread throughout the EU. The idea was strengthened in the 2013 revision of the Directive, which limits the disclosure which the law can require from small companies. As mentioned in Section 12.5, the EU now allows further exemptions from the rules for 'micro' entities.

We now look at the selected three EU countries in more detail as illustrations of how national rules in this area can differ.

14.3.2 France

Unlike the regulations in the US or the UK, the accounting laws and decrees of the French state apply not just to companies but to all business enterprises (with some exemptions for sole traders). The laws cover the keeping of accounting records and the needs of the taxation authorities as well as reporting to owners and creditors. The Commercial Code as amended in 2000 and 2009 provides a framework of general accounting rules. The emphasis of the Code is as much on the keeping of accounting records as on the preparation of annual financial statements.

The most important forms of business enterprise in France are the *société anonyme* (SA) and the *société à responsabilité limitée* (SARL). An SA is roughly equivalent to a UK public company and an SARL to a UK private company, although the SARL, originally based on the German GmbH (see Section 14.3.3), has some of the aspects of the UK partnership. The number of SAs and SARLs in existence at a given date is not published on a regular basis. In 2000 there were about 154,000 SAs and 742,000 SARLs.

Also in that year about 60 per cent of French business enterprises were neither SAs nor SARLs. Companies are also subject to the accounting requirements of the Companies Act as incorporated in the Commercial Code (Articles L232-1 to L233-27). The Act dates from 1966 but was amended in the 1980s to implement the Fourth and Seventh Directives of the EU.

The PCG uses size measured by balance sheet total, turnover and number of employees to determine choice of permissible financial statement formats and what must be disclosed in the Notes, but the cut-off points are not the same for each. In practice most companies, irrespective of size, use the standard formats (see Section 15.2.1). Because different size criteria are used for different purposes, no simple table, such as Table 14.2 for Germany, can be presented.

French companies are not allowed to use IFRS for unconsolidated statements.

14.3.3 Germany

In Germany, as in France, all types of business enterprise, including larger sole traders and all partnerships (general or limited), are subject to the accounting requirements of the Commercial Code (HGB), although the requirements vary with legal form, size and capital market orientation. Companies comprise primarily the *Aktiengesellschaft* (AG) and the *Gesellschaft mit beschränkter Haftung* (GmbH). The AG is the nearest analogy to a British plc or a French SA. The decision-making power and responsibility in AGs are concentrated within the management board (*Vorstand*). In addition, there is a supervisory board (*Aufsichtsrat*) of non-executive directors which, as well as members appointed by the shareholders' meeting, must include representatives from the workforce if the AG has 500 employees or more. The workforce representatives are either one third of the board (if the number of employees is between 500 and 2,000) or half (if the number of employees exceeds 2,000). A body such as the *Aufsichtsrat* is unknown to British law but has parallels in the Netherlands, and, optionally, in France. Its main functions are to appoint and dismiss the members of the management board, to supervise the latter body, and to approve the annual financial statements. The supervisory board may not assume management functions. Members of the management board are not eligible to join the supervisory board. The KonTraG of 1998 (see Chapter 20) passed control of audit assignments from the management board to the supervisory board, and strengthened the supervisory board in other ways.

The GmbH is quite similar to the AG in its basic legal characteristics, such as separate legal personality and the nature of the company (although it has partnership aspects). However, it has some quite distinct features, particularly the less restrictive legal regulations. Accordingly, a GmbH's formation is simpler and cheaper than that of the AG. Most German subsidiaries of foreign MNEs are set up as GmbHs. There is no requirement to establish a supervisory board unless the workforce exceeds 500 or it is required by the articles of association. Unlike in the UK and France, there is a separate body of private company law in Germany. A common business form is the one-person company.

Other legal forms of business enterprise include the *Einzelkaufmann* (sole proprietorship) as well as the OHG (partnership), KG (limited partnership) and the popular GmbH & Co. (a limited partnership with a corporation as a general partner).

Data on the number of companies are not provided by official sources. However, fairly recent data show that AGs decreased from a total of about 17,000 in 1926 to 3,000 in 1992 but rose to about 18,000 in 2006, then fell again to 13,000 in 2010 (du Plessis *et al.*, 2012, page 6). As with PLCs and SAs, only a minority of AGs (about 680) are listed on a stock exchange. By contrast, GmbHs rose from about 15,500 in 1909 to over 814,000 in 2006. Medium-sized and small businesses seem to prefer the GmbH form, whereas the AG is mainly used by companies that need to raise money on the capital market. In 2001 the largest 104 industrial enterprises in Germany by turnover were 27 AGs, 31 GmbHs, one KG, five OHGs, 39 GmbH & Co. KGs and one other.

In addition to the requirements of the Commercial Code, companies must follow rules laid down in the *Aktiengesetz* (AktG, Stock Corporation Law) and the *GmbH-Gesetz* (GmbHG, private company law), respectively. Larger partnerships and sole traders fall within the scope of the disclosure requirements of the *Publizitätsgesetz* (PublG, Disclosure Act) of 1969. The Act was introduced after the failures of some large partnerships had demonstrated that, although no shareholders were involved, there were major impacts on other stakeholders including governments (Eierle, 2005).

The extent to which the supplementary rules of the HGB have to be followed varies according to the size of the company. The size limits for small and medium-sized companies are shown in Table 14.2. A company has to meet at least two of the three size criteria in consecutive years. There are no exemptions for large companies. Small companies are permitted to file an abbreviated balance sheet, do not have to file an income statement and file abbreviated notes. Medium-sized companies are allowed to prepare an abbreviated income statement and omit an analysis of sales in their notes. Increases in limits, and other changes, are expected when the revised EU Directive of 2013 is implemented in Germany. As a result of implementing another EU Directive of 2012 (see Section 12.5), there are now 'micro' companies with further exemptions.

Individual companies are permitted to file IFRS financial statements, but if they do so must also prepare (but need not file) HGB statements. From 2007 onwards, all companies are required to file their financial statements electronically with the Federal Gazette, which forwards them to the local commercial Registry.

14.3.4 The United Kingdom

In the UK all business enterprises are required to keep accounting records for taxation purposes but specific financial reporting measurement and disclosure requirements apply only to companies, not to sole traders or partnerships (except limited liability partnerships, see below). Companies have been the most important form of business

Table 14.2 Size limits for small and medium-sized companies in Germany

	Small	Medium-sized
Turnover	€9.68 million	€38.50 million
Balance sheet total	€4.84 million	€19.25 million
Employees	50	250

enterprise since the nineteenth century. The most economically significant type of company recognized by UK company law is the public company limited by shares, and the most numerous is the private company limited by shares. The status of UK companies has been indicated in their names only since the implementation of the Second EU Directive on company law in 1980. 'PLC' or 'plc' indicates a public company and 'Ltd' a private company. There are also companies limited by guarantee and unlimited companies, but these are relatively rare. Table 14.3 gives the number of public and private companies limited by shares in the UK in 2015.

The essential difference between public and private companies is that only the former have the right to make an issue of shares or debentures to the public. To be a public company is a necessary but not a sufficient condition for a Stock Exchange listing. There are about 2,400 listed domestic companies in the United Kingdom.

As a result of the implementation of the EU Fourth Directive in 1981, the most important distinction within non-listed companies for financial reporting purposes is that between large, medium-sized and small companies. Size is measured by sales (turnover), balance sheet total (i.e. fixed assets plus current assets) and number of employees. The size limits vary from time to time. Table 14.4 sets out the requirements for 2016 onwards, which correspond to the maxima allowed by the EU. During 2015, the UK authorities were consulting on how to implement reduced requirements for 'micro' companies. This led to a special standard, FRS 105.

Large companies must file a full set of audited financial statements with the Registrar of Companies. Medium-sized companies are permitted to file and send to shareholders a balance sheet and an abbreviated profit and loss account (called an income statement in IFRS). Small companies are permitted to file an abbreviated balance sheet and are exempt from filing a profit and loss account. Subject to certain restrictions, 'small' private companies need not be audited.

Table 14.3 Companies limited by shares registered in the UK as at end February 2015

	000s	%
Public companies	7	0.2
Private companies	3,163	99.8
Total	3,170	100.0

Source: Companies House (2015).

Table 14.4 Size limits for small and medium-sized companies in the UK

	Small	Medium-sized
Turnover	£10.2 million	£36 million
Balance sheet total	£5.1 million	£18 million
Employees	50	250

The attractiveness of the private company form to small business enterprises, in particular, has restricted the number of partnerships, except for professional services. Limited liability partnerships (LLPs) were introduced mainly as a result of lobbying by large accountancy firms. LLPs are similar to companies in benefiting from corporate personality and limited liability (for all the partners) but each partner is taxed individually and an LLP is not liable to corporation tax. Audited financial statements which give a true and fair view and comply with accounting standards must be filed by LLPs with the Registrar of Companies. There were 56,000s LLPs in March 2015.

SUMMARY

France

- Accounting rules are codified in a Commercial Code (*Code de commerce*) and a national accounting plan (*Plan comptable général*, PCG), both of which have been influenced by EU Directives.
- The PCG is administered by the *Autorité des Normes Comptables* (ANC), a mixed public/private-sector body.
- IFRS is not allowed for accounting by individual companies.
- Tax legislation, which is compatible with the PCG, is a very important influence on the financial statements of individual business enterprises.
- The French accountancy profession is increasingly influential but has never issued accounting standards.
- Accounting rules apply to all business enterprises, the most important of which are SAs and SARLs.

Germany

- The major influences on German accounting are the Commercial Code and tax legislation.
- Germany, like the UK, has no national accounting plan.
- The standards set by the GASC do not apply to individual companies.
- IFRS is not allowed for reporting by individual companies, unless they also produce reports under the Commercial Code.
- Germany has a wide variety of forms of business enterprise. The most important are AGs, GmbHs and GmbH & Cos.
- The Code and tax laws apply to all business enterprises.

United Kingdom

- Company law is a major direct influence on corporate financial reporting but accounting standards are also very important.
- Both law and standards have been influenced by professional accountants, EU Directives, US GAAP and, especially since 2005, international standards.

- Accounting standards cover both disclosure and measurement but disclosure requirements vary considerably according to whether a company is public or private and whether it is large, medium-sized or small.
- The recognized standard-setter is the Financial Reporting Council, which is independent of government and the professional bodies; its standards are mandatory for all companies not using IFRS.
- The FRC has replaced FRSs and SSAPs with FRS 102, a version of the *IFRS* for *SMEs*.
- UK standard-setters have used the true and fair requirement to restrict or expand the detailed requirements of the Companies Act.
- The most important forms of business enterprise are public and private companies.

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Useful websites for Chapters 14 and 15

France

Association Francophone de Comptabilité	www.afc-cca.com
Autorité des Normes Comptables	www.anc.gouv.fr
Comité de la Réglementation Comptable	www.minefe.gouv.fr/themes/entreprises/compta_entreprises/directions_services-CNCompta-rcrc.php
Compagnie Nationale des Commissaires aux Comptes	www.cncc.fr
Ordre des Experts Comptables	www.expert-comptables.fr

Germany

Institut der Wirtschaftsprüfer	www.idw.de
Wirtschaftsprüferkammer	www.wpk.de

United Kingdom

Association of Chartered Certified Accountants	www.accaglobal.com
Chartered Institute of Management Accountants	www.cimaglobal.com
Chartered Institute of Public Finance and Accountancy	www.cipfa.org
Department for Business, Innovation and Skills	www.bis.gov.uk
Financial Reporting Council	www.frc.org.uk
Institute of Chartered Accountants in England and Wales	www.icaew.com
Institute of Chartered Accountants of Scotland	www.icas.org.uk
Registrar of Companies	www.companieshouse.gov.uk

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

14.1* The US, UK, France and Germany have evolved different answers to the question as to which business enterprises should be subject to accounting regulation. Which country, in your opinion, has got it 'right'?

14.2* In the UK, different types of individual company have different accounting rules. Why is the distinction between types of company not based solely on whether the company is public or private?

14.3 Is it useful to regulate, as for example in France, the keeping of accounting records, as well as the preparation of financial statements?

14.4 What are the arguments for and against a national accounting plan?

14.5 'The UK accountancy profession no longer has any influence on the accounting rules relating to individual financial statements.' Discuss.

14.6 Compare the composition and the roles of the FRC in the UK and the ANC in France.

14.7 Why has the FRC in the UK decided to converge (partially but not completely) UK standards for individual companies with IFRS for SMEs?

Appendix 14.1 Contents of the *Plan comptable général* (relating to financial accounting and reporting)*

BOOK I GENERAL PRINCIPLES

Title I – Object and principles of accounting

Title II – Assets

Title III – Liabilities

Title IV – Assets and liabilities from foreign currency changes

Title V – Expenses and income

BOOK II APPLICATION OF THE GENERAL PRINCIPLES

Title VI – Particular applications

Title VII – Recognition and measurement of fusions and similar

BOOK III MODELS FOR ANNUAL ACCOUNTS

Title VIII – Published financial statements

BOOK IV KEEPING, STRUCTURE AND FUNCTIONING OF ACCOUNTS

Title IX – Keeping, structure and functioning of accounts

**Authors' translation.*

Appendix 14.2 Financial accounting chart of accounts, Classes 1–7 in the *Plan comptable général* (ANC's translation of 1999 chart, adjusted for changes in 2014)

Balance Sheet					Operating	
Class 1	**Class 2**	**Class 3**	**Class 4**	**Class 5**	**Class 6**	**Class 7**
Capital (Owner equity, loans and debts payable)	Fixed assets	Stocks and work in progress	Debt receivable and payable	Financial	Charges	Income
10 Capital and reserves	20 Intangible assets	30	40 Suppliers and related accounts	50 Short-term investment securities	60 Purchases (except 603). 603. Change in stocks (consumables and goods for resale)	70 Sales of manufactured products, services, goods for resale
11 Profit or loss carried forward	21 Tangible assets	31 Raw materials (and supplies)	41 Customers And related accounts	51 Banks, financial and similar institutions	61 External services	71 Change in stocks of finished products and work in progress
12 Profit or loss for the financial year	22 Assets in concession	32 Other consumables	42 Personnel And related accounts	52 Short-term financial instruments	62 Other external services	72 Own work capitalized
13 Investment grants	23 Assets in progress	33 Work in progress (goods)	43 Social security and other social agencies	53 Cash in hand	63 Taxes, levies and similar payments	73
14 Tax-regulated provisions	24	34 Work in progress (services)	44 State and other public authorities	54 Expenditure authorizations and letters of credit	64 Personnel costs	74 Operating grants
15 Provisions for liabilities and charges	25	35 Product stocks	45 Group and partners/ associates	55	65 Other current operating charges	75 Other current operating income
16 Loans and similar debts payable	26 Participating interests and related debts receivable	36	46 Sundry debts receivable and payable	56	66 Financial charges	76 Financial income

Balance Sheet					Operating	
Class 1	**Class 2**	**Class 3**	**Class 4**	**Class 5**	**Class 6**	**Class 7**
17 Debts to participating interests	27 Other financial assets	37 Stocks of goods for resale	47 Provisional or suspense accounts	57	67 Extraordinary charges	77 Extraordinary income
18 Reciprocal accounts with branches	28 Cumulative depreciation on fixed assets	38	48 Accrual accounts	58 Internal transfers	68 Appropriations to depreciation and provisions	78 Depreciation and provisions written back
19	29 Provisions for diminution in value of fixed assets	39 Provisions for diminution in value of stocks and work in progress	49 Provisions for doubtful debts	59 Provisions for diminution in value of financial assets	69 Employee profit share, income and similar taxes	79 Charges transferred

15 Accounting rules and practices of individual companies in Europe

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OBJECTIVES

After reading this chapter, you should be able to:

- compare the financial statement formats used in France, Germany and the UK under national GAAPs;
- compare the accounting principles applicable to individual companies under the national GAAPs of France, Germany and the UK;
- describe the differences from IFRS and explain why they exist.

15.1 Introduction

Chapter 12 discussed, on an international basis, the extent to which financial reporting by individual companies differs from that of groups. Chapter 13 examined harmonization in Europe, particularly relating to individual (unconsolidated) reporting. Chapter 14 looked at rule-making for individual companies in three contrasting EU countries: the UK, France and Germany. This chapter looks at how accounting rules and practices differ for individual companies in those countries and compares their

rules and practices with IFRS. The chapter does not deal with consolidated statements (see Chapter 16).

The chapter demonstrates the important differences that still exist even after several decades of harmonization within the EU and after the adoption of IFRS for the consolidated statements of listed company groups. These differences exist both for financial statement formats (covered in detail in the EU Directive but barely mentioned in IFRS) and for accounting principles (covered in great detail in IFRS but more broadly and selectively in the Directive). The chapter assumes a knowledge of the rule-making bodies discussed in Chapter 14. The emphasis is on France and Germany rather than the UK, as the first two are better examples of countries whose domestic accounting systems differ considerably from IFRS. Unlike the UK, they differ in the absence of rules in areas covered by IFRS, as well as in having divergent rules in areas covered by both domestic standards and IFRS (Ding *et al*., 2007). In all three countries, but to varying extents, IFRS are influencing the content of national rules and practices. IFRS concepts and rules have had their greatest effect on individual companies in the UK, but their effect has also been felt in France and Germany.

15.2 France

15.2.1 Formats of financial statements

The primacy of the national accounting plan (PCG) in French accounting was stressed in Chapter 14. It is the PCG that regulates and sets out the prescribed formats for financial statements. These were not introduced in France by the EU Fourth Directive, but are a practice of long standing, although implementation of the Directive did bring about some changes. There are standard, abridged and extended formats, depending on size (as measured by balance sheet total, turnover and number of employees), but in practice almost all companies use the standard formats. These are set out in Appendix 15.1. Details of the composition of any item in the formats of an individual company can be found in the PCG. The standard balance sheet is usually presented in tabular (two-sided) form. The income statement may also be in this form, but most companies adopt the columnar form shown in Appendix 15.1. The revision of the Directive in 2013, which will be put into French law, removes the two-sided versions of the income statement.

Compared to the equivalent UK formats (see Appendix 15.3), more detail is shown on the face of the French balance sheet rather than in the notes. On the assets side are presented, in order of decreasing liquidity, fixed assets (classified into intangible, tangible and financial) and current assets. For the current year, three columns are shown for assets: cost, depreciation/amortization/impairment and net. The prior year figures are shown only net. Excluded from fixed and current assets, but shown separately at the foot of the balance sheet, are the *comptes de régularisation* which represent expenditure spread over more than one period. They include prepaid expenses, deferred charges, redemption premiums and negative unsettled exchange differences, only the first of which is considered an asset under IFRS.

On the liabilities and capital side are shareholders' funds, provisions and liabilities, with positive unsettled foreign exchange differences at the foot, which is not regarded as a liability under IFRS. Shareholders' funds are divided into:

1. share capital
2. share premiums
3. revaluation reserves
4. legal reserves
5. statutory reserves
6. tax-regulated reserves
7. other reserves
8. profit or loss brought forward
9. profit or loss for the year
10. investment grants
11. tax-regulated provisions.

Some of these items are typical of creditor/tax-oriented accounting. The legal reserve arises from the obligation of French companies to retain 5 per cent of each year's profit, less losses brought forward, until an amount of 10 per cent of issued share capital is reached. The reserve is undistributable but may be turned into shares. Revaluation reserves arise from revaluations required or allowed, from time to time in the past, by tax law. Some French company balance sheets still retain a revaluation reserve arising from the revaluation of non-depreciable fixed assets as at 31 December 1976. Tax-regulated reserves contain items such as untaxed long-term gains arising from the sale of fixed assets. Tax-regulated provisions are those which must be set up for a tax deduction when a company provides for expenses which exist only for tax purposes, such as excess depreciation (*amortissements dérogatoires*).

The income statement is usually presented in columnar format, with income and expenses subdivided into operating, financial and '*exceptionnel*'. The last of these is often translated into English as 'extraordinary' but it is a wider term than either extraordinary or exceptional.

The CNC recommended, and the ANC still recommends, publication of a funds statement (*tableau de financement*) based on working capital flows. This is mandatory for individual companies except those below a certain size. The OEC recommends a statement of cash flows (*tableau de flux de trésorerie*) more in line with international practice. For consolidated statements, this has grown in popularity. See Section 14.2.2 for details of institutions such as the ANC and the OEC.

Notes to the financial statements were not required by law in France before the implementation of the Fourth Directive in 1983 (Parker, 1996), although a number of schedules were required in addition to the balance sheet and income statement. The functions of the notes (*annexe*) are set out in the Commercial Code. They are:

1. completing and commenting on the information given by the balance sheet and the income statement;

2 supplying additional information, if following the rules is not sufficient to give a true and fair view;
3 mentioning, in exceptional cases, departures from an accounting requirement, if necessary to give a true and fair view;
4 describing and justifying changes in accounting policies or in the presentation of the financial statements.

All types of business enterprises, not just companies, are required to provide an *annexe*, although sole traders below a certain size are exempted. A simplified *annexe* is permitted for SAs, SARLs and partnerships below a certain size (as measured by balance sheet total, turnover and number of employees, but with different cut-off points than for formats).

The *annexe* plays an important role in connection both with the true and fair view requirement (see below) and with the close relationship between financial reporting and tax rules. Companies must disclose in the *annexe* material tax effects on the accounts. In practice, depreciation is the most important item affected. For a list of the items required to be disclosed in the *annexe* of an individual company, see Gélard (2001, pages 1098–9).

The easiest way to find examples of these practices (and those discussed below in Section 15.2.2) is to access the website of large French listed companies, looking for the financial statements of the parent company, rather than the consolidated statements (which use IFRS). Often the parent statements are near the end of the annual report and are available in English.

15.2.2 Accounting principles: differences from IFRS

Since the implementation of the EU Fourth Directive, French financial statements must display not only *régularité* (i.e. be in accordance with the rules) and *sincérité* (i.e. be in accordance with the spirit of the rules) but also give *une image fidèle* (the French version of a true and fair view, see Chapter 13). Regularity and sincerity are traditional French accounting concepts. As a true and fair view is an imported concept with no precisely defined meaning even in its country of origin, there has been much discussion in France as to its meaning and significance (e.g. Pasqualini, 1992). In practice, both individual company statements, which follow accounting principles designed to satisfy the needs of creditors and the tax authorities, and group financial statements, which follow accounting principles designed to appeal to equity investors both in France and overseas (i.e. IFRS), are deemed to be capable of giving a true and fair view.

In this chapter, the emphasis is on individual companies. For these, the recognition and measurement of assets and liabilities had traditionally followed a 'patrimonial' approach, i.e. one based on legal rights rather than on economic substance. The main valuation method is historical cost modified by prudence, with a tendency to understate rather than overstate profits and assets. This is what is to be expected of financial reporting driven by the needs of creditors and taxation rather than equity investment. The function of accounting in such an environment is, in a famous phrase, to act as the 'algebra of the law' (Garnier, 1947). In principle, the notion of patrimony

was changed by the CRC in 2004 to one of 'economic patrimony', i.e. based more on control than on ownership. However, leased assets are still not capitalized by lessees.

The CNC and the CRC (now replaced by the ANC, as explained in Chapter 14) decided not to extend permission to use IFRS to the financial statements of individual companies. However, in practice they did so progressively and partially in another way: by converging French rules with IFRS on certain topics. In particular, the CRC issued regulations on provisions, depreciation, the recognition and valuation of assets and the fair value of financial instruments, which follow closely the language of the relevant IFRS. Details of the regulations and the extent to which they bring French rules closer to IFRS are given in Richard and Collette (2012). The rules are inconsistent with tax law, but the tax authorities have been flexible and devices such as *amortissements dérogatoires* (see point 3 below) are used to overcome the inconsistencies. In order to achieve convergence with IFRS, it is necessary for the *Code de Commerce* to be amended, which is beyond the powers of the ANC (see Section 14.2.2). The recent revision of the PCG (*Réglement* no 2014-03) did not address this issue.

At the individual company level, there remain many differences of detail between French accounting principles and IFRS. These are not easy to summarize and are subject to change, but some examples are given below. More generally it should be noted that there has been no abandonment of the principles of prudence or of the classification of expenses by nature rather than by function (see Section 2.9.4).

1 Some items can be recognized as intangible assets (start-up costs, market share, portfolio of customers) which are not recognized under IFRS. Until 2016 and the implementation of the revised EU Directive, these and some other intangible assets were not required to be amortized. They must now be amortized over useful life.
2 It is not permissible to capitalize leases, because the legal form of the contract (i.e. rental) takes precedence over its economic substance (i.e. acquisition of a fixed asset). The CRC has accepted the IASB's definition of an asset but limited it to items which form part of a company's patrimony.
3 The rules for depreciation have been amended to follow those of IFRS rather than those of the tax authorities, but extra tax-driven depreciation (*amortissement dérogatoire*) must still be accounted for. The principle of the separation of financial and tax accounts has not been accepted.
4 Payments made for retirement benefits to employees must be recorded as an expense. The CNC stated a preference for recording a liability in the balance sheet, but disclosure in the notes is permitted instead. Given that making provision would not be tax deductible, the note treatment is usual.
5 The inclusion of deferred taxes in the income statement and balance sheet is permitted, but is extremely rare in practice.
6 Treasury shares are shown as non-current financial assets rather than as a negative component of equity.
7 According to the PCG, the percentage of completion method is the preferred method for long-term contracts. However, the completed contract method is permissible, and it is common because it is administratively easier.
8 Provisions are not discounted.

9 Unsettled losses on foreign exchange transactions are recognized in the profit and loss account but unrealized gains are not. Unsettled balances are shown in the balance sheet.
10 Extraordinary/exceptional items are broadly defined, but (at the time of writing) this is expected to change because of the revised EU Directive.
11 Prior year adjustments for correcting errors are not allowed.
12 There are no specific requirements for the disclosure of:
   - a primary statement of changes in equity;
   - discontinued operations.

Items 3, 4, 6 and 8 from the above list are illustrated below by quotations from the 2014 annual report of the parent company of L'Oréal, the French cosmetics group:

> Both straight-line and declining-balance depreciation is calculated over the actual useful lives of the assets concerned. Exceptionally, industrial machinery and equipment is depreciated using the straight-line method over a period of ten years, with all additional depreciation classified as accelerated tax-driven depreciation.
>
> Software of material value is amortised using the straight-line method . . . It is also subject to accelerated tax-driven amortisation which is recognised over a twelve month period.
>
> L'Oréal S.A. operates pension, early retirement and other benefit schemes for employees and retired employees in accordance with local legislation and regulations . . . No provision is recognized in the balance sheet for net unfunded obligations, which are shown in off-balance sheet commitments.
>
> Treasury stock acquired in the context of buyback programmes to be cancelled is recognised in other long-term investments.
>
> Translation differences on operating assets and liabilities and related hedging instruments are recognised in the balance sheet as *Unrealised exchange losses* or *Unrealised exchange gains*. A provision is recognised if the sum of these unrealised exchange gains and losses shows a potential exchange loss based on the overall exchange position of all currencies taken together.

Table 15.1 summarizes some of these major differences between French accounting principles and IFRS in individual financial statements. Delvaille *et al*. (2005) discuss the convergence of France (and Germany and Italy) with IFRS.

The IASB's *IFRS for SMEs* (published in 2009) has been examined in France. In reply to a consultation exercise of the European Commission, the ANC consulted various organizations, businesses and users. It expressed a negative view about the usefulness of the *IFRS for SMEs* in France (or even elsewhere in Europe), so it seems unlikely that *IFRS for SMEs* will be adopted in France.

15.3 Germany

15.3.1 Formats of financial statements

The *Handelsgesetzbuch* (HGB, Commercial Code) sets out the duty of businesses to prepare annual financial statements. The *Bilanzrechtsmodernisierungsgesetz* (BilMoG)

Table 15.1 Some differences between French GAAP and IFRS in individual company financial statements

Topic	France	IFRS
1 Establishment costs	Can be capitalized	Expensed
2 Leases	Cannot be capitalized	Capitalized
3 Liability for retirement benefits	May be disclosed in the notes	Must be recognized in the balance sheet
4 Presentation of an issuer's capital instruments	Based on legal form	Based on substance, including splitting instruments into debt and equity
5 Presentation of treasury shares	Non-current financial asset	Negative equity
6 Unsettled foreign-currency gains	Deferred	Taken to income
7 Construction contracts	Can be completed contract	Percentage of completion when criteria met
8 Measurement of provisions	Not discounted	Discounted
9 Extraordinary items	Wide definition	Not allowed
10 Correction of errors	Through income	Restatement

of 2009 exempts certain small unincorporated businesses. All businesses generally follow the format prescribed for companies (see Appendix 15.2), even though unincorporated businesses are not bound by a specific format. As there is no concept of materiality in German law, all the legal headings are shown in a financial statement, even if they contain only very small amounts.

The balance sheet may only take the double entry form (see Appendix 15.2). There must be identical classification of successive financial statements, and arbitrary changes in the form of presentation are prohibited. Exemptions for micro, small and medium-sized companies have been mentioned in Chapter 14.

As shown in Appendix 15.2, equity comprises subscribed capital, capital reserves, revenue reserves and retained income for the year. Capital reserves result from share premiums or other capital contributions by shareholders. Revenue reserves are created by management or by shareholder resolution from income of the year or a preceding year.

AGs are required to create legal reserves. Five per cent of net income for the year must be allocated to the reserves until the legal reserve and the capital reserves (excluding other capital contributions by shareholders) together equal 10 per cent of the nominal capital or such higher amount as is provided in the articles. Such reserves, designed to protect creditors, are also found in France (as already noted) and several other European countries and Japan, but not in the Anglo-Saxon world.

Some companies show, as part of revenue reserves, *Sonderposten mit Rücklageanteil* (special items with an equity element). These resulted from the setting up of tax-related provisions and provide good examples of tax regulations determining

the content of commercial financial statements. They were created, for instance, in order to store the capital gain when land and buildings are sold, in order to postpone tax. They were also used to record the additional depreciation allowed by tax law. The BilMoG does not allow any new special items to be set up. The item should be interpreted as both equity and a future tax liability.

The income statement must be presented vertically (see Appendix 15.2). Like a French statement, the basic structure contains the subdivisions of operational income and expenses, financial income and expenses and extraordinary income and expenses. Exemptions or abbreviations are permitted for micro, small and medium-sized corporations (see Chapter 14).

Two types of classification of costs are allowed. The 'total costs' method classifies expenses according to their nature (e.g. materials, wages and salaries, depreciation, etc.). Expenses are determined from a production aspect. Inventory increases and decreases as well as own work capitalized are shown as adjusting items in the calculation of total performance. This is the usual German format and, before the 1985 amendments to the HGB, it was the only format allowed. The 'cost of sales' method separates expenditure according to function, i.e. manufacturing, selling, general administration and other.

Cash flow statements are not generally required for individual company financial statements.

15.3.2 Accounting principles: differences from IFRS

The HGB summarizes the main accounting principles: prudence, accruals, consistency, going concern and individual valuation. As the implementation of the EU Fourth Directive, annual financial statements must, in compliance with principles of orderly bookkeeping, present a true and fair view[1] of net worth, financial position and results. If special circumstances result in the financial statements not showing a true and fair view, additional disclosures are required in the notes. The reference to compliance with the principles of orderly bookkeeping implies that the true and fair view concept is not overriding and does not require accounting principles to be adjusted (Alexander, 1993 and 1996; Ordelheide, 1993 and 1996). In case of doubt, observance of the concept is achieved by disclosures in the notes.

German accounting is in general rather conservative (Evans and Nobes, 1996), although this depends on what aspect of conservatism is being assessed (see Section 2.9). Adherence to historical cost is required, except for pension plan assets and for some hedge accounting (see Chapter 9 for a discussion of these topics under IFRS). This use of historical cost has a long history in German accounting. Over the centuries, Germany has sometimes allowed revaluations in periods, but has then returned to strict historical cost (or lower values) after various economic crises (Hoffmann and Detzen, 2013).

As explained in Section 14.2.3, expenses used to be considered tax deductible (in the *Steuerbilanz*) only if they were also included in the commercial accounts (*Handelsbilanz*). This led to considerable distortions in the presentation of net worth, financial

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[1]Unter Beachtung der Grundsätze ordnungsmässiger Buchführung ein den tatsächlichen Verhältnissen entsprechendes Bild . . . zu vermitteln (S. 264(2) of the Commercial Code). More literally, the last eight words could be rendered as 'to present a picture in accordance with the actual circumstances'.

position and results. However, the BilMoG removed this principle. For example, some costs of development can now be capitalized for accounting, but are treated as tax expenses whatever is done for accounting. Nevertheless, tax considerations can still affect accounting for individual company financial statements, if companies choose accounting options in order to keep in line with tax numbers or accounting measurements biased towards reducing profit. Several examples of tax influence were illustrated using quotations from a German annual report in Section 2.5.

Haller and Eierle (2004) summarize the discussion that has taken place in Germany as to the advantages and disadvantages of the application of IFRS to individual company statements. They characterize the activities of the government as primarily reactive (to capital market pressure and EU law), conservative and slow, but nevertheless steady and continuous. IFRS is allowed for unconsolidated statements, but only if HGB statements are also prepared for tax and dividend calculations. Therefore the use of IFRS in this context is not the normal practice.

Many amendments to accounting rules were made by the *Bilanzrechtsmodernisierungsgesetz* of 2009. These changes introduced some differences between accounting rules and tax law. However, principles for individual companies continue to differ in important respects from IFRS. Examples of some major features of German accounting are given below.

1 Land must be stated at acquisition cost, buildings and other fixed assets at acquisition or manufacturing cost net of systematic depreciation. Companies sometimes align depreciation with that allowed by tax law.

2 Tangible and intangible assets cannot be valued above cost. Intangible assets (other than goodwill) acquired must be capitalized and then depreciated according to their useful life. The costs of raising equity capital must not be included in the balance sheet. Any goodwill acquired by an individual company (by buying the net assets of a business) must be capitalized and must then be amortized over the anticipated period of usefulness. Since tax law provides for straight-line depreciation over a 15-year period, this is sometimes used. Stolowy *et al.* (2001) compared the German rules on intangible assets (before the BilMoG) with those of France and the IASB.

3 The HGB does not include any rules for the classification of leases. Therefore, they are normally classified according to tax rules, and are seldom capitalized by lessees (Garrod and Sieringhaus, 1995).

4 Marketable securities and other financial assets are not marked to market, except by financial institutions and for certain hedge accounting purposes. Derivatives are not accounted for unless they result in onerous contracts.

5 Valuation of inventories may be based on the weighted average method or by using FIFO or LIFO. As LIFO is acceptable for tax purposes, it is sometimes followed for accounting purposes, although now it can be used for tax even if not used for accounting. However, weighted average is more common than FIFO or LIFO. Inventories are written down to market value which, depending on the inventory, might be replacement cost or selling price less costs. For tax purposes, material and production overheads must be included in addition to direct material and production costs and, therefore, generally the cost of inventories is based on full production-related overhead absorption. The completed contract method

has to be used for long-term construction projects. Stage of completion accounting may be applied to the extent that the customer has agreed that a stage has been completed successfully. In general, the completed contract method is used for the recognition of revenues on construction contracts and services.

6 Non- or low-interest bearing receivables are discounted to present value, which is another illustration of conservatism in the German approach to accounting. General credit risk is usually covered by providing a lump-sum allowance on debtors, while uncollectable amounts are written off.

7 Interest on money borrowed for construction of assets can be expensed or capitalized.

8 Creditors are stated at the amount payable. Discounting of non- or low-interest bearing liabilities is not permitted. There is generally no classification on the face of the balance sheet into current and non-current liabilities; such detail is shown in the notes.

9 Long-term foreign-currency receivables and payables are translated at the original rate or at the closing rate, whichever avoids recognizing a gain or increases a loss.

10 Provisions must be set up for uncertain liabilities and for potential losses from contracted transactions. They are also required for repairs and maintenance expenses to be incurred within the first three months of the following year.

11 Pension commitments made after 1 January 1987 must be recorded, but accrual for earlier commitments is optional. The discount rate under the HGB is a seven-year smoothed rate published by the *Deutsche Bundesbank*, rather than the year-end rate on high-quality corporate bonds as it is under IFRS. No actuarial method is specified, whereas IFRS specifies the projected unit credit method. Also, unlike IFRS, there are no special treatments for actuarial gains and losses: they are added to the provision and charged in the income statement. A further difference is that some German pension obligations are not funded; that is, money is not set aside irrevocably to cover them.

12 There are no specific requirements for the disclosure of:
   - a cash flow statement (except for capital market companies that produce no consolidated statements);
   - a statement of changes in equity (except as above);
   - discontinued operations.

Items 1, 4, 5, 7, 9 and 10 from the above list are illustrated below with quotations from the 2014 annual report of the parent company of BASF, the chemical company headquartered in Germany:

> The cost of self-constructed assets includes direct costs . . . Financing costs . . . are not capitalized.
>
> For declining-balance depreciations, a systematic transition to straight-line depreciation takes place if this results in higher depreciation amounts.
>
> Inventories. They are carried at cost. Inventories are recognized at quoted, market or fair values if lower than cost. For raw materials and factory supplies, fair values constitue the replacement costs . . . The acquisition or production costs of raw materials, work in process, finished goods and merchandise are determined by the last-in-first-out (LIFO) method.

Construction in progress pertains especially to chemical plants under construction for BASF Group companies. Profits are recognized at final invoicing of a project or part of a project. Expected losses are recognized by write-downs to the lower fair values.

The special reserves were maintained . . . As these were established before the year in which the conversion... to the (BilMoG) took place. This referred primarily to transmissions of revealed inner reserves in accordance with Section 6b of the German Income Tax Act . . .

Other provisions are recognized for the expected amounts of contingent liabilities and probable losses from pending transactions as well as to cover omitted maintenance procedures as of the end of the year, which will be incurred within the first three months of the following year.

Non-current foreign-currency receivables are recorded at the rate prevailing on the acquisition date or at rate on the balance sheet date if lower. Non-current foreign-currency liabilities are recorded at the rate prevailing on the acquisition date or at the rate on the balance sheet date if higher.

Derivative financial instruments are treated as pending transactions and are generally not recorded as assets or liabilities.

Table 15.2 summarizes some major differences between German accounting principles and IFRS in individual company financial statements.

The IASB's standard on SMEs has been widely discussed in Germany but, given the many differences between IFRS and HGB financial statements and the unsuitability of the former for tax and dividend determination purposes, it is unlikely that the German legislator will implement the standard.

Table 15.2 Some differences between German GAAP and IFRS for individual company financial statements

Topic	Germany	IFRS
1 PPE	Cost or lower	Can be held at fair value
2 Goodwill	Amortized	Impaired
3 Contracts	Usually completed contract	Percentage of completion under some circumstances
4 Marketable securities	Lower of cost and market (except banks)	Fair value
5 Derivatives	Not recognized	Fair value
6 Inventories	LIFO common	LIFO not allowed
7 Interest on construction	Expensed or capitalized	Capitalized
8 Lessees	Generally do not capitalize	Capitalize
9 Repair provisions	Can be made when no obligation	Only when obligation
10 Employee benefit provisions	Smoothed bank rate; no special treatment of actuarial gains/losses	Market discount rate; Actuarial gains/losses taken to OCI
11 Policy changes and correction of errors	Through income	Restatement

15.4 United Kingdom

15.4.1 Formats of financial statements

The basic requirement of the Companies Act 2006, as applicable to individual companies, is that companies must prepare a balance sheet and a profit and loss account that comply *either* with EU-endorsed IFRS or with the detailed regulations made under the Act and with UK accounting standards. The former are termed 'IAS individual accounts'; the latter 'Companies Act individual accounts'.

Companies Act individual accounts must comply with the Act's mandatory formats for the balance sheet and profit and loss account, and with lists of items to be disclosed in the notes or statements. The formats (see Appendix 15.3) are derived from the EU Fourth Directive but the UK legislators, unlike those in some other member states (e.g. Germany), deliberately left them as flexible as possible. Thus UK companies may choose between two balance sheet formats and four profit and loss account formats (and more than that after the 2003 Accounts Modernization Directive, but with reductions that will follow when the 2013 revised Directive is implemented in the UK). The financial statements as actually published by UK companies (especially profit and loss accounts) do not at first sight greatly resemble the formats in the legislation. This is mainly because, apart from main headings, much detail is allowed to be shown in the notes and partly because the formats are sometimes followed in spirit rather than to the letter. As in France and Germany, there are exemptions and abbreviations for small and medium-sized companies.

UK GAAP, as found in FRS 102, requires the profit and loss account to include items of 'other comprehensive income' (OCI) or for OCI to be shown in a separate statement (see Section 9.10). This type of requirement was first set out in 1993 in the UK's FRS 3, and eventually spread to IFRS and US GAAP. Its presence in FRS 102 is more directly caused because that standard is based on IFRS for SMEs. The objective is to record those gains and losses that are not included in profit or loss, for example those arising on the revaluation of property, plant and equipment. This requirement has no equivalents in French and German domestic regulations.

Two other statements are required, also not by company legislation but FRS 102. They are the statement of changes in equity (see Section 6.3) and the cash flow statement. For micro companies, the requirements in standards can be replaced by the FRS 105 (see Section 14.2.4), which does not require a statement of changes in equity or a cash flow statement.

15.4.2 Accounting principles: differences from IFRS

As explained above, for unconsolidated statements and for consolidated statements of unlisted companies, UK law permits a choice of 'Companies Act accounts' (UK GAAP) and 'IAS accounts'. The difference between IFRS and UK GAAP is limited given that FRS 102 is based on IFRS for SMEs. However, a number of differences were inserted (see Section 14.2.4). Some of the differences relate to consolidation issues so are not the concern of this chapter. The differences related to individual company financial statements in 2016 are summarized in Table 15.3. Some of these, (e.g. lease

Table 15.3 Some differences between UK GAAP and IFRS for individual company financial reporting

Topic	UK GAAP	IFRS
1 Formats of statements	Specified by Companies Act	Not specified
2 Investment property	Fair value (unless undue cost or effort)	Cost or fair value
3 Government grants for assets	Choice of immediate income or deferred income	Choice of deduction from asset or deferred income
4 Intangible assets with indefinite lives	Amortized over 10 years	Must not be amortized but annually tested for impairment
5 Development costs meeting certain criteria	Can be capitalized	Must be capitalized
6 Interest on construction	Choice of expensing or capitalizing	Must capitalize
7 Financial assets	Two categories	Four categories
8 Pension obligations	Simplified calculation allowed	Projected unit credit method
9 Deferred tax	Based on 'timing differences plus'	Based on temporary differences
10 Lessees	Capitalize finance leases	Capitalize all leases (with small exceptions)
11 Revenue on contracts that can be reliably estimated	Percentage of completion method	On transfer of control to customer

accounting and deferred tax) can have major effects. Some of the differences (e.g. contract revenue and lease accounting) have arisen because IFRS has changed since IFRS for SMEs and FRS 102 were written.

SUMMARY

General

- Accounting rules and practices differ more internationally for individual companies than for groups, as illustrated by financial statement formats.

France

- Balance sheet and income statement formats for individual business enterprises are set out in the PCG. Several items in these formats (e.g. legal reserves and tax-regulated provisions) are the product of creditor- and tax-oriented accounting.

- All financial statements must give a true and fair view but this principle largely affects the Notes rather than the balance sheet and income statement.
- Traditional accounting theory as applied to the financial statements of individual companies has a 'patrimonial' approach to the recognition and valuation of assets and liabilities.
- As a result, the rules relating to, inter alia, deferred taxation, leases and foreign-currency gains differ as between French GAAP and IFRS (and between French GAAP for individual financial statements and French GAAP for consolidated statements).

Germany

- Formats for balance sheets and income statements are laid down in the HGB. All items must be disclosed, whether or not they are material.
- The financial statements of individual companies were once largely determined by tax rules, though the formal link has now been abolished.
- Rules and practices on several topics differ from those under IFRS, for example in the areas of inventories, contract accounting and goodwill.

United Kingdon

- UK companies can choose UK GAAP or IFRS for unconsolidated financial statements.
- Financial statement formats in UK GAAP have been kept as flexible as possible within the constraints of EU Directives.
- Although UK GAAP is now based on IFRS for SMEs, there are some important remaining differences between UK GAAP and IFRS, such as in the areas of lease accounting, deferred tax and the amortization of intangible assets.

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Further reading

See Chapter 14.

Useful websites

See the websites listed at the end of Chapter 14.

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

15.2* 'US accounting is better than accounting under German national rules.' Discuss.

15.2* Discuss the advantages and disadvantages, for a country such as Germany, that would follow from requiring or permitting companies to apply IFRS in their individual financial statements.

15.3 Compare the influence of tax law on financial reporting in the UK with its influence in Germany.

15.4 Discuss the view that the individual company financial statements in Germany are useful only for tax purposes.

15.5 Why are leased assets accounted for differently in individual company financial statements in the UK and France?

15.6 The formats in the appendices to this chapter, relating to three EU countries, all comply with the EU Fourth Directive. Comment on the differences between them.

15.7 'German accounting rules for individual companies are ideal for domestic companies with no international connections.' Discuss.

Appendix 15.1 Formats for French financial statements (2014 *plan comptable*)

STANDARD SYSTEM BALANCE SHEET FORMAT (in tabular form)

ASSETS	
FIXED ASSETS	Subscribed capital uncalled
	Intangible fixed assets:
	Establishment costs
	Research and development costs
	Concessions, patents, licences, trade marks, processes, software, rights and similar assets
	Goodwill
	Other
	Intangible fixed assets in progress
	Payments on account
	Tangible fixed assets:
	Land
	Constructions
	Technical installations, plant and machinery, equipment and fixtures
	Other
	Tangible fixed assets in progress
	Payments on account
	Financial fixed assets:
	Participating interests
	Debts receivable related to participating interests
	Portfolio long-term investment securities
	Other long-term investment securities
	Loans
	Other
	Total I

STANDARD SYSTEM BALANCE SHEET FORMAT (in tabular form)

	ASSETS
CURRENT ASSETS	Stocks and work in progress:
	Raw materials and other consumables
	Work in progress [goods and services]
	Semi-finished and finished products
	Goods for resale
	Payments on account on orders
	Debts receivable:
	Trade debtors and related accounts
	Other
	Subscribed capital – called but not paid
	Short-term investment securities:
	Own shares
	Other securities
	Short-term financial instruments
	Liquid assets
	Prepayments
	Total II
	Deferred charges (**III**)
	Loan redemption premiums (**IV**)
	Realizable exchange losses (**V**)
	Overall total (I + II + III + IV + V)

	LIABILITIES*
CAPITAL AND RESERVES	Capital [of which paid up ...]
	Premiums on shares issued, mergers, contributions ...
	Revaluation reserve
	Equity accounted reserve
	Reserves:
	Legal reserve
	Statutory or contractual reserves
	Tax-regulated reserves
	Other
	Profit or loss carried forward
	Sub-total: Net position
	Investment grants
	Tax-regulated provisions
	Total I
PROVISIONS	Provisions for risks
	Provisions for expenses
	Total II
	Convertible debenture loans
	Other debenture loans
DEBTS PAYABLE	Loans and debts payable to credit institutions
	Loans and sundry financial debts payable
	Payments on account received on orders in progress
	Trade creditors and related accounts
	Tax and social security debts payable
	Creditors for fixed assets and related accounts
	Other debts payable
	Short-term financial instruments
	Deferred income
	Total III
	Realizable exchange gains **(IV)**
	Overall total (I + II + III + IV)

Note: *This official translation is not a good one; 'shareholders' equity and liabilities' would be better.

Appendix 15.2 Formats for German financial statements (before implementation of the 2013 revised Directive)

BALANCE SHEET

Fixed assets

Intangible assets
- Internally generated rights and similar rights
- Concessions
- Goodwill
- Payments on account

Tangible assets
- Land, land rights and buildings including buildings on third-party land
- Technical equipment and machines
- Other equipment, factory and office equipment
- Payments on account and assets under construction

Financial assets
- Shares in affiliated enterprises
- Loans to affiliated enterprises
- Participations
- Loans to enterprises in which participations are held
- Long-term investments
- Other loans

Current assets

Inventories
- Raw materials and supplies
- Work in progress
- Finished goods and merchandise
- Payments on account

Receivables and other assets
- Trade receivables
- Receivables from affiliated enterprises
- Receivables from enterprises in which participations are held
- Other assets

Securities
- Shares in affiliated enterprises
- Other securities

Cheques, cash in hand, central bank and postal giro balances, bank balances

Prepaid expenses

Deferred tax assets

Equity

Subscribed capital

Capital reserves

Revenue reserves

Retained profits/accumulated losses brought forward

Net income/net loss for the year

Provisions

Provisions for pensions and similar obligations
Tax provisions
Other provisions

Creditors

Loans
Liabilities to banks
Payments received on account of orders
Trade payables
Liabilities on bills accepted and drawn
Payable to affiliated enterprises
Payable to enterprises in which participations are held
Other creditors

Deferred income

Deferred tax liabilities

INCOME STATEMENT – Format 1

1 Sales

2 Increase or decrease in finished goods and work in process

3 Own work capitalized

4 Other operating income

5 Cost of materials

- Cost of raw materials, supplies and purchased merchandise
- Cost of purchased services

6 Personnel expenses

- Wages and salaries
- Social security and other pension costs

7 Depreciation

- On intangible fixed assets and tangible assets as well as on capitalized start-up and business expansion expenses
- On current assets to the extent that it exceeds depreciation which is normal for the company

8 Other operating expenses

9 Income from participations

10 Income from other investments and long-term loans

11 Other interest and similar income
12 Amortization of financial assets and investments classified as current assets
13 Interest and similar expenses
14 Results from ordinary activities
15 Extraordinary income
16 Extraordinary expense
17 Extraordinary results
18 Taxes on income
19 Other taxes
20 Net income/net loss for the year

INCOME STATEMENT – Format 2

1 Sales
2 Cost of sales
3 Gross profit on sales
4 Selling expenses
5 General administration expenses
6 Other operating income
7 Other operating expenses
8 Income from participations
9 Income from other investments and financial assets
10 Other interest and similar income
11 Amortization of financial assets and investments classified as current assets
12 Interest and similar expenses
13 Results from ordinary activities
14 Extraordinary income
15 Extraordinary expense
16 Extraordinary results
17 Taxes on income
18 Other taxes
19 Net income/net loss for the year

Appendix 15.3 Formats for British financial statements (before implementation of the 2013 revised Directive)

The formats below are those required by legislation. It is important to note, however, that:

1. many companies disclose items preceded by Arabic numerals in the Notes and not in the statements themselves;
2. appropriations of profit must be disclosed, although they are not in the formats;
3. letters and numerals are for reference only and are usually omitted;
4. immaterial items may be omitted;
5. many companies do not adhere absolutely and precisely to the formats;
6. for some items (e.g. called-up share capital not paid) there is a choice of position.

Balance sheet Format 2 is a horizontal version of balance sheet Format 1. Profit and loss account Formats 3 and 4 are horizontal versions of profit and loss account Formats 1 and 2. The horizontal versions are seldom used, and are not illustrated here.

BALANCE SHEET – Format 1

A Called-up share capital not paid

B Fixed assets

I. Intangible assets
- 1 Development costs
- 2 Concessions, patents, licences, trade marks and similar rights and assets
- 3 Goodwill
- 4 Payments on account

II. Tangible assets
- 1 Land and buildings
- 2 Plant and machinery
- 3 Fixtures, fittings, tools and equipment
- 4 Payments on account and assets in course of construction

III. Investments
- 1 Shares in group undertakings
- 2 Loans to group undertakings
- 3 Participating interests
- 4 Loans to undertakings in which the company has a participating interest
- 5 Other investments other than loans
- 6 Other loans
- 7 Own shares

C Current assets

I. Stocks
1 Raw materials and consumables
2 Work in progress
3 Finished goods and goods for resale
4 Payments on account

II. Debtors
1 Trade debtors
2 Amounts owed by group undertakings
3 Amounts owed by undertakings in which the company has a participating interest
4 Other debtors
5 Prepayments and accrued income

III. Investments
1 Shares in group undertakings
2 Own shares
3 Other investments

IV. Cash at bank and in hand

D Prepayments and accrued income

E Creditors: amounts falling due within one year
1 Debenture loans
2 Bank loans and overdrafts
3 Payments received on account
4 Trade creditors
5 Bills of exchange payable
6 Amounts owed to group undertakings
7 Amounts owed to undertakings in which the company has a participating interest
8 Other creditors including taxation and social security
9 Accruals and deferred income

F Net current assets (liabilities)

G Total assets less current liabilities

H Creditors: amounts falling due after more than one year
1 Debenture loans
2 Bank loans and overdrafts
3 Payments received on account
4 Trade creditors
5 Bills of exchange payable
6 Amounts owed to group undertakings
7 Amounts owed to undertakings in which the company has a participating interest
8 Other creditors including taxation and social security
9 Accruals and deferred income

I Provisions for liabilities and charges
- **1** Pensions and similar obligations
- **2** Taxation, including deferred taxation
- **3** Other provisions

J Accruals and deferred income

K Capital and reserves

I. Called-up share capital

II. Share premium account

III. Revaluation reserve

IV. Other reserves
- **1** Capital redemption reserve
- **2** Reserve for own shares
- **3** Reserves provided for by the articles of association
- **4** Other reserves

V. Profit and loss account

Note: for group accounts, minority interests are to be inserted above or below K.

PROFIT AND LOSS ACCOUNT – Format 1

1 Turnover
2 Cost of sales
3 Gross profit or loss
4 Distribution costs
5 Administrative expenses
6 Other operating income
7 Income from shares in group undertakings
8 Income from participating interests
9 Income from other fixed asset investments
10 Other interest receivable and similar income
11 Amounts written off investments
12 Interest payable and similar charges
13 Tax on profit or loss on ordinary activities
14 Profit or loss on ordinary activities after taxation
15 Minority interests
16 Extraordinary income
17 Extraordinary charges
18 Extraordinary profit or loss
19 Tax on extraordinary profit or loss
20 Minority interests

21 Other taxes not shown under the above items
22 Profit or loss for the financial year

PROFIT AND LOSS ACCOUNT – Format 2

1 Turnover
2 Change in stocks of finished goods and in work in progress
3 Own work capitalized
4 Other operating income
5 (a) Raw materials and consumables
(b) Other external charges
6 Staff costs:
(a) Wages and salaries
(b) Social security costs
(c) Other pension costs
7 (a) Depreciation and other amounts written off tangible and intangible fixed assets
(b) Exceptional amounts written off current assets
8 Other operating charges
9 Income from shares in group undertakings
10 Income from participating interests
11 Income from other fixed asset investments
12 Other interest receivable and similar income
13 Amounts written off investments
14 Interest payable and similar charges
15 Tax on profit or loss on ordinary activities
16 Profit or loss on ordinary activities after taxation
17 Minority interests
18 Extraordinary income
19 Extraordinary charges
20 Extraordinary profit or loss
21 Minority interests
22 Tax on extraordinary profit or loss
23 Other taxes not shown under the above items
24 Profit or loss for the financial year

Part V

GROUP ACCOUNTING ISSUES IN REPORTING BY MNEs

16 Group Accounting

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OBJECTIVES

After reading this chapter, you should be able to:

- explain why the United States and the United Kingdom adopted consolidated financial statements before the countries of continental Europe;
- discuss the different concepts of a 'group' and how they are reflected in IFRS and US GAAP;
- outline the effects on group accounting of the harmonization programmes of the European Union and the International Accounting Standards Board;
- discuss the varying approaches in IFRS and US GAAP to purchase accounting, pooling (uniting) of interests, proportional consolidation, the equity method and goodwill;
- describe how publication requirements differ between the United States, the United Kingdom, Germany and France.

16.1 Introduction

Both theory and practice in the field of group accounting have differed substantially from country to country. The differences have been of four types:

1 differences in the rate of adoption of consolidated financial statements;
2 differences in the concept of a group and the scope of the group;
3 differences in the techniques of consolidation;
4 differences in what is published by companies.

The harmonization activities of the International Accounting Standards Board (IASB) and the European Union have substantially narrowed these differences, but they are unlikely to be removed entirely. The main aim of this chapter is to describe the differences and, so far as is possible, to explain them.

Discussion in the chapter deals mainly with the IASB, the European Union and the United States. Three EU countries contributed significantly to developments in consolidation: France, Germany and the UK. For listed companies in those countries, IFRS is now required for consolidated statements. For unlisted companies, IFRS is allowed but many groups still use national GAAP. Consolidation practices in Japan largely derive from the United States, and are dealt with in Chapter 11. That chapter also discusses China, where consolidation is a recent idea and approximately follows IFRS.

16.2 Rate of adoption of consolidation

Consolidated financial statements were first produced in the United States. A number of US companies published such statements before the beginning of the twentieth century (Bores, 1934; Hein, 1978; Mumford, 1982) but it was the United States Steel Company – which was chartered in New Jersey in 1901 and published consolidated statements from its inception – that set a pattern (Walker, 1978).

The faster rate of adoption in the United States than elsewhere can be explained in part by the earlier development there of the holding company. This was connected to the fact that each state has a separate legal system, so that combinations of businesses from more than one state were more easily achieved by leaving the separate legal entities in place. One consequence of the wave of mergers in the United States at the start of the twentieth century was that groups of companies, not individual companies, carried out commercial and industrial activities. There were no legal or regulatory barriers to hold up new accounting techniques and a social climate existed in which innovation was highly regarded.

In Europe, both holding companies and consolidated statements were a later development. In the United Kingdom it was not until the second wave of merger activity (1916–22) that holding companies became an important form of business organization. The earliest consolidated statements appear to date from 1910 (Edwards

and Webb, 1984). The first British book on the subject, *Holding Companies and their Published Accounts* by Gilbert Garnsey, was published in 1923, by which time consolidation had become almost universal in the United States. Even when UK company law was extensively reformed in 1929, consolidated financial statements were still not introduced as a legal requirement. Dunlop Ltd led the way during the 1930s, but consolidations remained relatively uncommon (Bircher, 1988), although in 1939 the London Stock Exchange required consolidated statements as a condition of new issues. The Second World War intervened and it was not until 1947 that group accounts (normally in the form of consolidated financial statements) were finally required by law.

Thus, both the need for the new technique (the rise of the holding company) and recognition of the need came more slowly in the United Kingdom than in the United States. Garnsey (1923) stated that 'the natural reluctance of the people of this country to change is too well known to require any comment' and he placed the blame on the directors who were, under British law, responsible for published accounts. It is possible that the obligation (not present in the United States) to publish the holding company's own balance sheet may have acted as a deterrent to the publication of a consolidated balance sheet.

Consolidated financial statements developed even later in continental Europe. The earliest Dutch example, according to Bores (1934), was Wm H. Müller & Co. of the Hague in 1926 (see also, Zeff *et al*., 1992). Swedish law required consolidation from an Act of 1944. German companies did not start consolidating until the 1930s and none was obliged by law to do so until 1965. French companies were even slower. According to the 1968 annual report of the *Commission des Opérations de Bourse*, only 22 French companies published a consolidated balance sheet for 1967. As late as 1983 only about 75 per cent of French listed companies published consolidated statements and they were not legally bound to do so until 1986. Bensadon (2010) provides an extensive study of the development of consolidation in France. Consolidated statements were still very rare in the 1980s in such countries as Italy, Spain, Greece and Luxembourg. This, however, changed in the 1990s as a result of the EU Seventh Directive (see Section 16.4 below).

In Japan, the Commercial Code does not require consolidated statements, and even the Securities Law (introduced in the late 1940s) saw them as supplementary statements until 1992. In China, consolidation was a development of the 1990s.

In some other countries, consolidation is either non-existent or recent. For example, consolidated statements were not required in India until 2001 or in Turkey until 2003.

16.3 The concept of a 'group'

The production of consolidated financial statements assumes that a group of enterprises can be regarded as a single accounting entity. In defining the boundaries of such an entity, it is necessary to ask, first, for whom is information about the entity intended, and, second, for what purpose the information is to be provided. The US

and IASB conceptual frameworks assume that financial statements are particularly designed for existing and potential investors. Furthermore, the emphasis was, until recently, on the shareholders of the parent or holding company. This is the 'parent company' concept of a group. In its pure form, it could be criticized because:

- It assumes that a group consists of a parent company that dominates a number of dependent or subsidiary companies. It does not allow for the possibility that the group has been formed by the merger of two or more companies of approximately equal size; nor does it allow for companies dominated jointly by more than one company, or for companies over which another company exercises a significant influence but not control.
- It treats all interested parties other than equity shareholders of the parent as unimportant users, so non-controlling interests (formerly called 'minority interests') are shown outside of shareholders' funds.

The 'parent company' concept is generally based on legal control. This is usually achieved by majority shareholder voting rights, but it can also be attained (where company legislation permits, as it does in Germany) by the use of 'control contracts' whereby one company places itself under the legal domination of another.

A possible alternative is the 'entity' concept of a group. This emphasizes the economic unity of all enterprises in the group and treats all shareholders similarly, whether controlling or not. Even before the adoption of IFRS, non-controlling interests were shown as part of equity under Australian, German and Italian practice. This makes sense because they clearly do not meet the definition of liabilities (see Chapter 6). IAS 27 originally stated that non-controlling interests should not be shown as parent company equity but allowed them to be shown as group equity. A revision of 2003 requires this latter treatment, which is in line with the entity concept. IFRS 10 confirms that position. It can be argued that this 'entity' way of looking at a group is more appropriate for such users as employees and managers. A group that consists of, say, two equally large companies can also be accommodated more easily under the entity concept.

Whichever of the two concepts is being used, the group is defined in principle as a set of entities that operate together because they are controlled by the same parties. Neither the parent company concept nor the entity concept, however, takes account of enterprises that are linked to the group but where there is neither legal dominance nor an economic unit. These situations are, however, covered by the 'proprietary' concept, which emphasizes not legal control nor economic unity but ownership or proprietorship, which gives the possibility of exercising 'significant influence' over commercial and financial policy decisions. Under this concept a proportionate share of the profit or loss for the year and a proportionate share of the assets and liabilities are brought into the consolidated statements, either item by item ('proportional consolidation') or on a 'one-line' basis (the 'equity method'). In practice, no GAAP is based consistently on any of these concepts, and all three need to be invoked to explain IFRS and US GAAP.

The IASB and FASB conceptual frameworks say nothing yet (in late 2015) about 'the reporting entity' but a joint exposure draft (IASB, 2010) proposed that a group should be seen as the parent and the things it controls. The changing requirements of laws and standards on the scope of the group are considered in Section 16.5.

16.4 Harmonization from the 1970s onwards

The two major attempts at harmonization of group accounting, by the IASC/B and the EU, were very different in nature. However, they came together when the EU required all its listed companies to use IFRS for their consolidated statements, from 2005 with a few exceptions. This section looks first at the main features of international standardization, then at the EU's Seventh Directive.

16.4.1 International standards

The IASC began by concentrating with some success on producing a standard that would encourage consolidation in countries where it was still underdeveloped, and on drawing up a list of practices acceptable to both US and UK accountants. The Committee deliberately excluded from the original standard (IAS 3, Consolidated Financial Statements, of 1976) two areas – pooling of interests (merger accounting) and the treatment of goodwill on consolidation – where practice was divergent. Later the IASC produced a more comprehensive set of standards: IAS 22 (amended in 1993 and 1998 and replaced by IFRS 3 in 2004) on business combinations; IAS 27 to replace IAS 3; IAS 28 on associated entities; and IAS 31 on joint ventures. Further amendments were made by the IASB in 2003, 2004 and 2008. Then there were major revisions and new standards (IFRSs 10 to 12) in 2011.

IAS 22 restricted the use of pooling/merger accounting (see Section 16.6 for more detail) to those rare cases where it was impossible to identify an acquirer. IFRS 3 abolished the pooling method. For acquisitions, IAS 22 required capitalization of goodwill and its amortization over its useful life. Until 1998, IAS 22 had limited the useful life of goodwill to 20 years; however, the standard was revised in that year to allow longer periods to be used, approximately as in the United Kingdom's FRS 10 of 1997. Under IFRS 3, goodwill is tested annually for impairment rather than being amortized. This converged with US practice since 2001.

IAS 27 based its definition of a subsidiary on the existence of control and did not permit the exclusion of subsidiaries on the grounds of dissimilarity or for any other reason. IAS 28 required the use of equity accounting for associates; and IAS 31 had a choice of proportional consolidation (benchmark treatment) and equity accounting (allowed alternative) for joint ventures. In areas of measurement, this amounted to a stricter set of rules than that of the EU Seventh Directive (see below), although the Directive has more detailed definitions of a subsidiary and more detailed format requirements. As explained below, these standards were largely replaced by IFRSs 10 and 11 in 2011.

16.4.2 EU harmonization

The European Union tackled the difficult task of producing rules that were enforceable by statute and acceptable to countries of such diverse practices as the United Kingdom, Germany, France, the Netherlands and Italy. The origins of the Seventh Directive can be traced back to a supplementary paper to the Elmendorff Report (see Chapter 13). The early draft (e.g. as published by the European Commission

in 1976) was closely based on German rules. This influence was gradually much reduced by the addition or substitution of many Anglo-American features (Diggle and Nobes, 1994). The existence of IAS 3 probably had an impact on the negotiations. Table 16.1 lists the main provisions of the Directive and the major source country for each provision.

Adoption of the Seventh Directive in 1983 was a notable event in the history of consolidated accounting. National laws implementing the Directive were required to be enacted by 1988 and their provisions were to apply by 1990. However, these requirements were not met (see Table 16.2).

The Directive was a compromise between the 'parent company' concept and the 'entity' concept, with a leaning towards the former. The financial statement formats of the Fourth Directive apply 'without prejudice to the provisions of this Directive and taking account of the essential adjustments resulting from the particular characteristics of consolidated accounts as compared with annual accounts' (Art. 17).

One of the purposes of a Directive on group accounting is clear: as for other aspects of accounting, harmonization should enable easier international comparison of financial statements (whether of multinationals or not) and easier preparation of financial statements for multinationals. However, it is also clear that the Seventh Directive on company law had two additional purposes behind it. First, if harmonization of practices had been the only aim, the simplest method would have been to have no consolidation, for this was the prevailing practice throughout much of the

Table 16.1 Main provisions of the Seventh EU Directive

	Article no.	Some source countries
1	Subsidiaries are defined largely in terms of *de jure* rather than *de facto* criteria	UK
3	Consolidation to include foreign subsidiaries	UK, NL, France
4	Consolidation irrespective of legal form of subsidiary	Germany
4	Consolidation by all types of company	UK, NL
7	Exemption from preparation of group accounts by wholly owned subsidiaries	UK, NL, France
13	Subsidiaries may be excluded on various grounds	UK
14	Compulsory exclusion of certain dissimilar subsidiaries [deleted 2003]	UK
16	True and fair view	UK, NL
17	Uniform formats to be used	Germany, France
19	Goodwill to be calculated at date of first consolidation	UK, NL
19	Goodwill to be based on fair values	UK, NL
29	Tax-based valuations to be 'corrected' or at least disclosed	–
30	Goodwill to be depreciated or written off	UK, NL
32	Proportional consolidation allowed for joint ventures	France
33	Equity method for associated companies	UK, NL, France

Table 16.2 Implementation of the Seventh EU Directive by pre-2004 EU members

	National laws	In force (year ends)
France	1985	1986 (Listed); 1990 (Others)
Germany	1985	1990
Greece	1987	1990
Luxembourg	1988	1990
Netherlands	1988	1990
Spain	1989	1991
United Kingdom	1989	1990
Belgium	1990	1991
Denmark	1990	1992
Austria	1990*	1994
Italy	1991	1994
Portugal	1991	1991
Ireland	1992	1993
Finland	1992*	1993
Sweden	1995	1997
Norway‡	1998	1998

Notes:
*Less than complete implementation;
‡Member of the European Economic Area, not the EU.

European Union in the early 1970s when drafting began. Thus, one aim of the Seventh Directive was to 'improve' practice by requiring consolidation for all subsidiaries of groups above a certain size. A second aim was particularly apparent in the drafts of the Directive: the disclosure of information to assist in the supervision of multinationals by host countries.

The 'supervision' aim of the Directive is far less visible in the adopted version than it was in the drafts of 1976 and 1978. It is clear in these drafts that the European Commission had uses in mind for consolidated financial statements additional to the appraisal of groups by shareholders and investors. There were proposals for consolidation by groups under the control of unincorporated businesses, and by EU companies that were unconnected except for their common control by an undertaking outside the Union. In the former case, it was suggested by some that the various worldwide commercial interests of the Roman Catholic Church would have to be consolidated because they were controlled by the Pope! In the second case, a 'horizontal consolidation' would be required from the various EU subsidiaries of the Ford Motor Company, although none of them owned or controlled any of the others. Which EU shareholders or investors would benefit from these consolidations? What would it have to do with harmonization of accounting? Persistent asking of these questions no doubt helped to remove the mandatory status of these provisions.

Returning to harmonization, it should be clear that the aim was not uniformity. Harmonization does not imply the imposition of a rigid and narrow set of rules. There is no doubt, however, that the Directive was a major step towards the production by European companies not only of more consolidated statements but also of

more comparable ones. It also had the effect of bringing continental European practice more into line with that of Anglo-Saxon countries. Nevertheless, the Directive was only adopted as the result of lengthy discussion and a series of compromises, and many options are available to member states.

The impact of the Directive was greatest on those member states such as Greece, Italy, Luxembourg, Portugal and Spain, where consolidations had been rare. A detailed survey of the options adopted in the member states is provided by FEE (1993). The Directive also affects the laws of new member states of the EU. Some countries closely associated with the European Union implemented laws based on the Fourth and Seventh Directives; for example, Switzerland (Zünd, 1993) implemented a law based loosely on the Seventh Directive in 1991. In the case of the non-EU members of the European Economic Area (e.g. Norway), implementation was also required.

There were amendments to the Seventh Directive in 2003, after the Enron scandal in the United States (see Chapter 8). These widened the scope of the definition of a subsidiary (see 16.5.4). Then, in 2013, the Fourth and Seventh Directives were combined and revised. However, this did not involve any changes of substance to consolidated financial statements. Of course, to the extent that IFRS is required for consolidated statements, most of the content of the national laws based on the Directives becomes irrelevant.

16.5 Definitions of entities in which the group invests

The concept of a group was discussed in Section 16.3. In this section we look at the definitions of subsidiaries, associates and joint arrangements in practice. At the end of the section, there is a summary concerning the widening scope of the group.

16.5.1 IFRS

IFRS 10 defines a subsidiary as an entity controlled by an investor. This means that the investor has power to affect the amount of its returns from the subsidiary. This power arises from rights, such as voting rights or rights to appoint directors. The rights must already exist, but sometimes include voting rights that would be obtained if convertible debentures were turned into voting shares. Appendix B to IFRS 10 contains a lengthy discussion, with examples, about how to assess the existence of control. To take two examples:

- Suppose that entity A owns 45 per cent of the voting shares of entity X, and that the other shares in X are widely held. It is then likely that X is a subsidiary of A, although the existence of control should be assessed and confirmed before consolidating.
- Suppose that entity B owns 40 per cent of the voting shares in entity Y, and has an option to buy a further 30 per cent. We then need to know whether the option is 'substantive'. For instance, if the exercise price was very high in relation to the economic value of the shares, the option would not be substantive, and Y would not be consolidated.

Since the revision of IAS 27 in 2003 and the publication of IFRS 5 in 2004, there are no grounds (except immateriality) under which a group may exclude any of its subsidiaries from consolidation. IFRS 5 requires the net assets of subsidiaries that are intended to be sold to be shown on the balance sheet as 'held for sale'. More disclosures are needed if the subsidiary is large enough to be a discontinued operation.

Under IFRS 11, joint arrangements are divided into joint operations (e.g. where several venturers contribute the use of assets to a project) and joint ventures (i.e. those that are entities). The key identifying feature of a joint arrangement is the existence of a contract between the operators/venturers that requires their unanimous consent for the direction of any activities that affect the returns on the JV arrangements. Joint operations need no special accounting: each venturer accounts for the assets that it controls. Joint venture entities are treated as associates (see Section 16.6).

IAS 28 defines an associate as an entity over which an investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is an alarmingly vague concept. It is defined as the power to participate in the investee's financial and operating policy decisions, but is not control or joint control over those policies. To make the concept operational, significant influence is presumed where an investor has 20 per cent or more of the voting power of the investee. Similarly, if the investor has less than 20 per cent, the presumption is that there is no significant influence. However, these presumptions are rebuttable. Again, it is not clear whether the associate should be seen as part of the group. Certain aspects of the treatment of associates (see Section 16.6) suggest that it is.

16.5.2 United States

US practice can be interpreted as being based on the parent company concept plus the use of the proprietary concept for corporate joint ventures and for associates. However, until 2001, extensive use was made of 'pooling of interests' which is discussed further in Section 16.6. This would seem to be based upon the entity concept and is difficult to reconcile with a parent company approach. Its use in the United States probably owed more to management's need to boost earnings per share than to theoretical considerations.

The US definition of a subsidiary, like that in IFRS, is based on the concept of 'control'. Accounting Research Bulletin No. 51 stated that the purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. A holding of more than 50 per cent of the voting shares of another company is a condition pointing towards consolidation. This is different from the somewhat wider IFRS or European concept of *de facto* control. The narrower US concept enabled 'special purpose vehicles' (SPVs) to be set up that were controlled but not majority-owned. These could then be used to hide liabilities, as was the case with Enron, the US energy-trading company that collapsed spectacularly in 2001. In 2003, the FASB issued an interpretation (FIN 46) that requires the consolidation of certain SPVs called variable interest entities.

16.5.3 Examples of the US/IFRS difference

One major example of the difference in scope of consolidation was the Enron case, as noted above. However, this only became obvious after the crisis. Other examples have been disclosed by non-US companies that are registered with the SEC. For example, China Petroleum and Chemical noted[1] as follows:

> Under IFRS, the Group consolidates less-than-majority-owned entities in which the Group has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities, and proportionately consolidates jointly controlled entities in which the Group has joint control with other venturers. However, US GAAP requires that any entity of which the Group does not have a controlling financial interest not be consolidated nor proportionately consolidated, but rather be accounted for under the equity method. Accordingly, certain of the Group's subsidiaries, of which the Group owns between 40.72% to 50% of the outstanding voting stock, and the Group's jointly controlled entities are not consolidated nor proportionately consolidated under US GAAP and instead accounted for under the equity method.

International Power, a UK-based company, reported as follows:

> Under IFRS, the Group consolidates 100% of the assets and liabilities of entities over which it exercises control and excludes any minority share from total equity attributable to equity holders of the parent.
>
> Control is achieved where the Group has the power to govern the financial and operating policies of the entity so as to obtain benefit from its activities.
>
> In December 2003, the US Financial Accounting Standards Board issued FIN 46R (Consolidation of Variable Interest Entities). This statement is an interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, and addresses the consolidation of variable interest entities (VIEs). FIN 46R requires the consolidation of a VIE by the primary beneficiary if the majority of the expected losses are absorbed and/or a majority of the entity's expected residual returns are received by the primary beneficiary.
>
> An entity is a VIE if the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support or as a group the holders of the equity investment at risk lack the characteristics of a controlling financial interest, such as the ability through voting rights to make decisions about an entity's activities, the obligation to absorb the expected losses of the entity and the right to receive the expected residual returns of the entity.
>
> Under the provisions of FIN 46R the Group has deconsolidated three entities:

Subsidiary	% Ownership	Region
Al Kamil Power Company SAOG	65	Middle East
Perth Power Partnership	70	Australia
Thai National Power Company Limited	100	Asia

> Each of the deconsolidated entities holds power generation assets with long-term sales contracts. An analysis of the sales contracts identified that the Group does not absorb the majority of the expected losses and expected residual returns of these entities and therefore cannot be the primary beneficiary as defined by FIN 46R.

[1]The types of extracts in this section were available in annual reports up to those of 2006. After that, reconciliations from IFRS to US GAAP were not required, so the information is no longer given.

16.5.4 The scope of the group widens over time

As explained in Section 16.3, various concepts of a group are implied by the consolidation requirements of IFRS or national GAAPs, although no GAAP consistently applies a single concept. One issue, related to these concepts, which has varied greatly over time and internationally, is the scope of the group. When consolidation began in the United States, the scope of the group was generally restricted to *companies* (as opposed to a wider set of entities including partnerships) which were wholly owned and based in the United States. More generally, at various times and places, the following have been *excluded* from consolidation:

- less-than-wholly-owned entities;
- less-than-majority-owned entities, even if controlled;
- foreign subsidiaries;
- subsidiaries that were not companies;
- subsidiaries in different industries from most of the group (e.g. a bank owned by a motor group);
- temporarily-controlled subsidiaries.

Nobes (2014) discusses these and other exclusions. In general, they have been abandoned over time. One might have expected the United States to take lead in focusing on the 'economic group' (i.e. a set of controlled entities) in order to give useful information to investors. However, the US has lagged behind IFRS and many national GAAPs in widening the scope of the group to all controlled entities. At the other extreme, some countries (notably France and Spain) had extended consolidation on a partial basis to joint venture entities even though the assets and liabilities of the venture were not controlled by any of the venturers.

By contrast, the earliest German law on consolidation, in 1965, set out a clear concept of control. At first sight this is surprising, because one might have expected Germany to concentrate on legal and tax aspects such as ownership of shares in legal entities. An explanation is that Germany has always seen consolidated statements as serving a different (investor) purpose compared to unconsolidated statements. Therefore, an economic/control viewpoint was appropriate. It took many decades for such clarity to arrive in IFRS, but it has largely done so with IFRSs 10 and 11. Even now, US GAAP is not so clear; see 16.5.3 above.

16.6 Techniques of consolidation

16.6.1 Introduction

There have been considerable differences in the techniques of consolidation. In summary, the most important points are:

- The purchase (acquisition) method of accounting for business combinations has been the most common in all jurisdictions, but aspects of it have differed internationally.

- Pooling of interests (also known as uniting of interests and merger accounting) was a fairly common accounting practice only in the United States and the United Kingdom. It is no longer permissible under either IFRS, US GAAP or UK GAAP, so all business combinations are treated as purchases by one party or the other(s).
- The calculation and presentation of non-controlling (minority) interests have varied.
- Proportional consolidation is common in France and in some other continental European countries, but was relatively rare in the United Kingdom and the United States. It was allowed under IFRS until 2012, and was common among listed companies based in France and Spain.
- The equity method has been used in varying ways.
- The calculation and treatment of goodwill vary from country to country.

These issues are now discussed in turn.

16.6.2 Purchase accounting

Purchase (or acquisition) accounting assumes that one party (usually the parent company of a group) has bought a controlling interest in another entity. This often corresponds well with the facts of a business combination.

Under the purchase accounting method of consolidation, the group is seen as buying all the individual assets and liabilities of the new subsidiary. It is therefore necessary to establish the ‘cost’ to the group of each of these. This is unlikely to be the carrying value that was recorded for the assets and liabilities in the financial statements of the subsidiary. The ‘cost’ to the purchaser is measured by estimating the fair values (current market values) of the individual assets and liabilities obtained by the group.

Often, because the acquirer expects to make better use of the assets than the acquiree, the acquirer pays more for the net assets than their total fair value. This gives rise to the recognition of goodwill (see Section 16.6.7).

Both US GAAP and IFRS require a group to identify as many intangible assets as possible, leaving as little as possible to be called goodwill. Consequently, it would be normal to put a value on purchased brand names. It is also necessary to value contingent liabilities although not, as yet, contingent assets. However, plans for restructuring create neither liabilities nor contingent liabilities in the acquiree at the date of acquisition.

The treatment of the various expenses of the purchase has also varied over time. These expenses (including the fees of merchant bankers, lawyers and accountants) can be very large. Until recently, these expenses were treated as part of the purchase consideration, so they increased the size of goodwill. As a result, the management of the acquiring company avoided showing them in the income statement. However, revisions of 2008 to IFRS and US GAAP (IFRS 3 and SFAS 141, respectively) require the expenses to be shown in the income statement.

As an example, consider the following:

- Company P pays $100m cash for all the shares in Company S.
- The book value of the net assets of S at the date of acquisition is $60m.

- The fair value of the net assets of S at the date of acquisition is $80m.
- Restructuring of S is expected to cost $15m.
- The fees of external lawyers, bankers and the accountants are $10m.

Given these facts, the goodwill would now be calculated as $20m, i.e. cost of $100m minus fair value of net assets of $80m. The $10m fees would be charged, as they are spent, in the income statement. Before the amendments to the standards, goodwill was $30m under IFRS (cost of $110m minus net assets of $80m), and $45m in US GAAP (cost of $110m minus net assets of $65m). Before the Seventh Directive, in Germany, the calculation would have been based on the book value of the net assets.

16.6.3 Pooling (uniting) of interests

It is often possible to guess that a pooling has taken place by looking at a company's complex name. For example, 'GlaxoSmithKline' results from a pooling of GlaxoWellcome and SmithKlineBeecham, which themselves had been formed by poolings.

In the United States APB Opinion 16 (paragraph 12) described the pooling of interests method, as follows:

> The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined corporation.

In summary, in a pooling there was no revaluation of assets to fair values at the date of acquisition and no goodwill on consolidation. The investment in the subsidiary in the acquiring company's books was valued at the nominal value of shares issued. The consolidated retained profits were simply the sum of the retained profits of the companies concerned. No distinction was drawn between pre- and post-acquisition profits because, of course, there was deemed to be no acquisition. For the same reason, the subsidiary's profits were included in the consolidated income statement as from the first day of the year of acquisition. In periods of rising prices, the pooling of interests method generally produced the following two main differences from the purchase method: first, the fixed assets will be reported at lower amounts, and goodwill is not created; and second, net income reported after the business combination will be higher because of the depreciation of the lower carrying amounts of the fixed assets and less impairment (or, formerly, amortization) of goodwill (both of which are reported as expenses).

In the US, Opinion No. 16 (1970) specified the elaborate criteria by which, until 2001, a pooling was to be distinguished from a purchase. Pooling could not be applied where shares were acquired for cash; it *had to be* applied in certain specified circumstances where shares were acquired for a consideration other than cash.

Accounting Trends and Techniques (AICPA, 2000) reported 54 new business combinations accounted for as poolings of interests and 343 accounted for by the purchase method, from a sample of 600 companies. Figures for the previous three years showed somewhat smaller numbers of poolings and purchases.

In 1999, the FASB announced its intention to abolish poolings, on the grounds that the method amounted to a choice in most cases. The SEC supported this position. However, that decision was very unpopular with companies because of the enormous amount of goodwill amortization expense that would have arisen if large poolings had been accounted for as purchases. For an examination of this, see Ayers *et al*. (2000). One way of reducing the opposition to the elimination of poolings was to amend the requirements on goodwill, as examined below.

The elimination of pooling was achieved by the FASB in 2001 with the publication of SFAS 141. However, poolings up to 30 June 2001 are allowed to remain in place in subsequent financial statements, so poolings will continue to be relevant for an understanding of financial statements prepared under US GAAP for many years to come. In IAS 22, the IASB had already in the 1990s restricted the use of poolings more than in the US, but pressure was on it to follow the US and to eliminate poolings, and it did so for 2005 onwards in IFRS 3.

The United Kingdom was the only country in the EU where pooling of interests (merger accounting) were of any importance. The method had been retrospectively legalized in 1981 and was the subject of an accounting standard (SSAP 23) in 1985. SSAP 23 was replaced in 1994 by FRS 6, which was designed to make merger accounting rare by only allowing it when it was impossible to identify an acquirer or an acquiree. UK GAAP is now based on IFRS for SMEs (see Chapter 15), and it does not allow poolings.

However, US GAAP, IFRS and UK GAAP only abolished poolings/unitings/merger accounting prospectively. That is, old poolings remain in place in the group statements, such as those of GlaxoSmithKline mentioned at the beginning of this sub-section. All the former accounting (e.g. the absence of goodwill) is still in place.

16.6.4 Non-controlling interests

The concept of non-controlling interests (formerly minority interests) was introduced in Section 16.3. As mentioned there, diverse practice has existed, including presentation as a kind of liability, as in US GAAP until 2010. However, it is now internationally agreed that non-controlling interests should be shown as shareholders' equity but not parent's equity (e.g. IFRS 10, para. 22).

Nevertheless, there is still lack of consensus on how to calculate the size of non-controlling interests. Traditional practice has been to measure it at the date of acquisition as the non-controlling interests' share of the net assets at fair value. This was found in national rules (e.g. FRS 6 in the UK). It was also the original requirement in IFRS 3, and it remains an option (para. 19). However, the other option is to value the non-controlling interest at its fair value (i.e. at the value of the shareholding rather than the proportion of the value of the net assets). This is the required treatment in US GAAP (revised SFAS 141) from 2009. So, a new difference between IFRS and US GAAP has been created. This also affects the calculation of goodwill, as explained with a numerical illustration below (see 16.6.7).

16.6.5 Proportional consolidation

In the EU, before the adoption of IFRS for many consolidated statements in 2005, the use of proportional (proportionate, pro rata) consolidation to account for joint ventures in consolidated statements varied considerably. Under domestic French and Spanish rules, the method is required for joint ventures. In Germany, proportional consolidation had not been allowed before the implementation of the Seventh Directive. In that country, the Accounting Directives Law of 1985 permitted, but did not prescribe, proportional consolidation for joint ventures, and the method was taken up by some groups. In the United Kingdom, proportional consolidation was not allowed by FRS 9 for joint venture entities. In the United States, proportional consolidation is not generally allowed, but is used in the construction and extractive industries (ASC 810-10-45-14). Faced with mixed international practice, the IASC included proportional consolidation as an option in IAS 31. Indeed, it was said to be a preferred option.

An obvious disincentive to the use of proportional consolidation is that, compared with the equity method, it increases the recorded amount of the group's liabilities. Conversely, it increases the consolidated cash and sales figures. In practice, under IAS 31, national traditions continued. That is, proportional consolidation was extensively used in French and Spanish IFRS statements but not in Australian or UK IFRS statements (see Section 7.4). This variation in practice harmed comparability. Further, it can be argued that proportional consolidation is not appropriate because the venturer does not control any of the venture's assets (Milburn and Chant, 1999). In the end, the IASB abolished proportional consolidation when it issued IFRS 11 in 2011. Joint venture entities must now be accounted for like associates, as explained immediately below.

IFRS 11 also deals with 'joint venture operations'. For example, several companies might provide different assets to a project. They each account for their own assets/liabilities and for the contractual share of revenues/expenses. This is sometimes called 'proportional' but is not consolidation.

16.6.6 Equity method

IAS 28 requires use of the equity method for associates and joint ventures in consolidated statements. The investment is valued in the balance sheet at cost plus a proportionate share of the retained profits since the date of acquisition. The income statement does not include the detailed revenues and expenses (as would be the case for a subsidiary company or under proportional consolidation). Instead, there is a figure for the proportionate share of the associate's profit.

In the United States, APB Opinion No. 18 (now ASC 323-10) stipulates that the equity method should be used to account for investments in unconsolidated subsidiaries, for investments in corporate joint ventures (in most industries) and for investments in companies in which at least 20 per cent but not more than 50 per cent of the voting stock is held and the investor has the ability to exercise significant influence over the operating and financial policies of the investee. US practice also allows the equity method to be used in parent company financial statements (not that these are often published) as well as in the consolidated financial statements.

The Seventh Directive required the equity method as the way of accounting for associates in consolidated statements. Thus, the laws of EU countries contain this provision. The equity method is also the Directive's optional method for joint ventures if proportional consolidation is not used. However, the laws or standards of various countries have narrowed the choice. As examples, UK standards (both FRS 9 and the later FRS 102) have *required* the equity method for joint ventures, whereas French law *requires* proportional consolidation.

Nobes (2002) examines the international spread of the equity method over time. He suggests that most of the uses of the equity method are inappropriate; and that the 20 per cent threshold for significant influence (see Section 16.5.1) was arrived at by accident. In particular, assuming that the group is the parent plus its controlled entities, the group's share of an associate's profit is not realized in (and could not be successfully demanded by) the group. So why is it included in the group's income? A possible alternative to the equity method is the use of fair values for the investment, that is, to treat the investment as an available-for-sale financial asset under IAS 39 or the equivalent under IFRS 9 (see Section 9.5).

16.6.7 Goodwill

Goodwill (or the 'consolidation difference') refers to the difference that arises on consolidation because the amount paid by the investor company is greater or less than its proportionate share of the fair value of the net assets of the investee at the date of acquisition. One important international difference was that US calculations (until 2009) were required to take account of the acquirer's intentions. In common with IFRS 3, US GAAP does not now allow this. The difference is numerically illustrated in sub-section 16.6.2.

The calculation of the size of any non-controlling interests (see Section 16.6.4) will also affect the calculation of goodwill. For example, suppose the following facts:

- P acquires 80 per cent of the shares of S.
- P pays 100.
- The remaining 20 per cent of the shares are valued at 22 (less per share than P's stake because P paid a premium in order to get control).
- S's net assets at book value are 70, but at fair value are 90.

Under the traditional non-US method (still optional under IFRS 3), the goodwill is:

$$100 - (80\% \text{ of } 90) = 28$$

Under the US method, the consideration is grossed up, and the goodwill is:

$$(100 + 22) - 90 = 32$$

Having calculated goodwill, US practice until 2001 was to amortize it over a period of not more than 40 years (APB Opinion No. 17), although the SEC required a shorter period in certain industries. Now, under SFAS 142 (codified as ASC 350-20-35-1), instead of amortization, there must be annual impairment calculations. IFRS has also changed over the years. Up until 1998, IAS 22 allowed a group to write goodwill off immediately against reserves. This was then a common practice in the UK and Germany, for example. In 1998, IAS 22 was amended to require capitalization, amortization, a rebuttable presumption of useful life of up to 20 years, and annual

impairment tests if a life of over 20 years was used. In 2004, the IASB replaced IAS 22 by IFRS 3, converging with US GAAP by abolishing amortization and requiring annual impairment calculations.

However, a new difference between US GAAP and IFRS has arisen. Impairment calculations of goodwill are burdensome. As a result, the FASB (from 2011) allows an entity to first assess whether it is more likely than not that there has been no impairment. If so, no impairment calculation is necessary. IFRS has not included this optional simplification.

Ding *et al.* (2008) try to explain the changes in accounting for goodwill over time and internationally. They suggest that as the key users of consolidated accounting change, so does its purpose, and then the accounting practices such as the treatment of goodwill.

US and IFRS practices have also differed in the treatment of negative goodwill on consolidation. Under IAS 22, negative goodwill was required to be credited against positive goodwill, and then credited to income against the anticipated losses or over the life of fixed assets purchased. In the United States (until 2009), negative goodwill arose only very rarely because any apparent excess of net assets was allocated proportionately against the fair values of fixed assets other than investments. IFRS and US GAAP now require any negative goodwill to be credited to income. However, that is not the end of the possibilities. Under French and German national rules, negative goodwill is shown as a reserve; and under the UK's FRS 10 (withdrawn for 2015 onwards) it was a negative asset.

Peterson and Plenborg (2010) look at the implementation of goodwill impairment tests under IFRS 3 and IAS 36 by Danish companies. They find that companies use different approaches and that many seem not to comply with the standards. This is evidence of the novelty and complexity of the requirements.

For associates and joint ventures accounted for by the equity method or by proportional consolidation, goodwill is also identified and then annually tested for impairment. Under IFRS, the goodwill amount remains as part of the investment but this is separately disclosed in the notes. Under US GAAP, it is included with other goodwill.

The adoption of IFRS within the EU has continued the general effect of the Seventh Directive to harmonize the originally very diverse treatments of goodwill within EU member states, largely using the Anglo-Saxon rather than the former continental European model. A study of goodwill practices for a wide selection of countries in the 1990s was provided by Nobes and Norton (1996). Whether international differences in goodwill rules affect the behaviour of companies was examined by Choi and Lee (1991), who found evidence that UK companies were prepared to pay more for subsidiaries than US companies were, because UK companies did not then need to amortize goodwill, whereas US companies did.

16.7 Publication requirements and practices

As explained in Chapter 5, listed companies in the EU must use IFRS for their consolidated statements. Member states may give permission for unlisted parents to use IFRS for their consolidated statements also, and this has generally been done. For the parent company's *unconsolidated* statements, some countries insist on IFRS for listed

companies (e.g. the Czech Republic), some allow IFRS for any parent (e.g. the UK) and some ban IFRS for all unconsolidated statements (e.g. France). Chapter 12 gives more detail on this. Consequently, publication rules and practices vary between the EU member states and the United States. For example, in 2015, assuming that the company is a parent:

- US companies publish consolidated balance sheets, income statements (nearly always split into 'profit or loss' and 'other comprehensive income'), statements of changes in equity, and cash flow statements, but do not publish any parent company statements.
- EU listed companies publish IFRS consolidated balance sheets, income statements (split, as in the US), statements of changes in equity and cash flow statements, plus any parent statements as required by national law (see below).
- UK listed companies that choose to use domestic rules for the parent's unconsolidated statements publish full IFRS consolidated statements (as above), plus the unconsolidated balance sheet, but not the other statements, of the parent company under UK GAAP.
- UK companies that are unlisted and are using UK GAAP publish the same number of consolidated statements as under IFRS, plus the unconsolidated balance sheet, but not the other statements, of the parent company.
- In France and Germany, a full set of parent statements is required under domestic rules, in addition to a full set of consolidated statements (under IFRS or not). However, except under IFRS, the full set does not include OCI or a statement of changes in equity. For unlisted companies, it might not include a cash flow statement.

In the EU, member state laws (based on the Directive) exempt some smaller groups from preparing consolidated statements. The size criteria for exemption from consolidation are subject to change and are not uniform across the member states of the EU. However, all are based on sales, balance sheet total and number of employees (set at a maximum of 250). The first two measures can be 'gross' (i.e. an aggregation without consolidation adjustments) or 'net' (i.e. after appropriate consolidation adjustments). Some member states use gross measures, some net measures and some a combination of both.

US consolidation practice is governed by the rules of its SEC and by relevant accounting standards. Consolidated financial statements must be filed each year by all companies subject to SEC jurisdiction (see Chapter 8). Financial statements of any unconsolidated subsidiaries must also be filed. Article 4 of Regulation S-X sets forth the SEC's requirements as to the form and contents of consolidated and combined financial statements. It requires, *inter alia*, that consolidated statements clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries. It further requires the consolidation of majority-owned subsidiaries only; the reasons for inclusion and exclusion of subsidiaries; separate disclosure of minority (non-controlling) interest in capital, in retained earnings and in consolidated income for the year; and elimination of inter-company transactions and items.

SUMMARY

- Consolidated financial statements were adopted first by the United States, followed by other Anglo-Saxon countries, then the Netherlands, Germany, Sweden and France.
- The main concepts of the 'group' are the parent company concept based on legal control, the entity concept based on economic unity and the proprietary concept based on ownership.
- Harmonization of consolidated financial statements was successfully attempted both internationally (IASs 22, 27, 28 and 31, IFRS 3) and within the European Union (the Seventh Directive). Listed companies in EU countries follow international standards from 2005. From 2011, the main relevant standards are IFRSs 10 and 11.
- Some differences remain between IFRS and US GAAP. The differences cover, *inter alia*, rules and practices relating to what constitutes a group, publication requirements and techniques of consolidation (e.g. the equity method and goodwill).

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

16.1* Discuss different possible interpretations of the concept of a group, and how these may relate to different styles of corporate governance and company financing.

16.2* 'The EU Seventh Directive was a much more useful harmonizing tool than the Fourth Directive was.' Discuss.

16.3 Why did the practice of consolidated reporting arise in the United States earlier than in France?

16.4 Compare, as between US GAAP and IFRS, the consolidation of subsidiaries and the calculation and treatment of goodwill on consolidation.

16.5 To what extent did the EU Seventh Directive harmonize consolidation accounting between Germany and the United Kingdom?

16.6 One of the original aims of the Seventh Directive was to assist with the supervision of multinational enterprises by their host countries. Examine and discuss arguments for and against such a desire for supervision.

16.7 Explain the alternative uses of the equity method and how these differ as between US GAAP and IFRS.

17 Foreign currency translation

John Flower

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OBJECTIVES

After reading this chapter, you should be able to:

- outline the nature of the foreign currency translation problem and the choice between historical rates and current rates;
- explain the difference between the translation of transactions and the translation of financial statements;
- summarize the different ways in which transactions can be translated;
- set out the three methods of translating financial statements that were used until the 1970s, and the arguments for and against each;
- understand the principal provisions of US GAAP and IFRS on currency translation;
- show how translation gains and losses can be accounted for;
- briefly summarize the purchasing power parity (PPP) theorem and the Fisher effect.

17.1 Introduction

17.1.1 Terminology

First, it is necessary to define the word 'translation'. When used by accountants it has a special technical meaning, namely, the process whereby financial data expressed in terms of one currency are restated in terms of another. The meaning of 'translation' will be illustrated with a simple example. A British company, which draws up its financial statements in pounds sterling, has among its assets a $100 bill (bank note). In order for this asset to be included in the company's balance sheet (or statement of financial position), it must be expressed in terms of pounds: one cannot add together dollars and pounds and arrive at a meaningful result. If the current exchange rate is £1 = $2, it would be reasonable to calculate the pound value of the $100 bill as £50, so that the asset '$100' can be included in the balance sheet at the value of £50. Using the accountant's terminology, the asset has been 'translated' from dollars to pounds.

A clear distinction should be made between 'translation' and 'conversion'. With conversion, the asset is actually changed from one currency to another, as when dollars are exchanged for pounds in a bureau de change. With 'translation' the asset remains unchanged; the dollar bill itself remains the same; only the basis of measurement is changed. English-speaking accountants have borrowed the term 'translation' from the linguists to describe their procedure, but this undoubtedly confuses many non-accountants who assume that the accountants are referring to language translation. French accountants use the term '*conversion*' for currency translation which also causes confusion when, in the English version of French reports, the French term is incorrectly rendered as 'conversion'. The German term is '*Währungsumrechnung*' (literally, currency recalculation), which is unambiguous as it is used only for the accountant's procedure. However, it too is often rendered incorrectly as 'currency conversion' in the English version of German reports. It would seem that the accountants' nice distinction between 'translation' and 'conversion' is often not appreciated by laypersons.

This chapter examines the financial reporting aspects of foreign currency translation. We examine the arguments in favour of various methods, and then concentrate on the current requirements of US GAAP and IFRS. The management of foreign exchange is a different subject, which is dealt with in other textbooks (e.g. Buckley, 2012).

17.1.2 The translation problem

If the exchange rate between the pound and the dollar, for example, were always the same, there would be no difference of opinion about the translated pound value of an asset with a dollar value of $100. However, exchange rates are not fixed. Table 17.1 shows the exchange rate of the pound against the US dollar and the German and Brazilian currencies over a 45-year period. From 1999, the German mark is subsumed into the euro. The table presents the number of units of the foreign currency that could be bought with £1 on the foreign exchange market at various dates. It can be seen that there have been very substantial fluctuations. For example, in 1970 £1 bought $2.39; by 1984, this had fallen to $1.15; but by 1990 it had recovered to $1.93; a value to which it returned in 2004 after some intermediate falls. In 2008, the pound lost about a quarter of its value against the dollar and the euro, and even

Table 17.1 The value of £1 sterling in three other currencies at various dates

Date	US dollar	German mark (euro from 1999)	Brazilian cruzeiro/ cruzado/real
31.12.70	2.39	8.73	11.85
31.12.75	2.02	5.29	18.34
31.12.80	2.38	4.67	156.22
31.12.85	1.44	3.56	15,152.81
31.12.86	1.47	2.86	21,970.05
31.12.87	1.87	2.96	135.22*
31.12.88	1.81	3.22	1,384.81
31.12.89	1.62	2.73	18.24*
31.12.90	1.93	2.88	341.37
31.12.92	1.51	2.44	18,729.90
31.12.93	1.49	2.56	471.28*
31.12.95	1.55	2.22	1,508.06
31.12.96	1.70	2.64	1.76*
31.12.99	1.62	1.61†	2.89
31.12.00	1.49	1.60	2.91
31.12.02	1.61	1.54	5.70
31.12.04	1.93	1.41	5.13
29.12.06	1.96	1.49	4.20
31.12.07	2.00	1.36	3.55
31.12.08	1.46	1.05	3.41
31.12.10	1.54	1.16	2.59
31.3.15	1.48	1.38	4.79

Notes: *Introduction of new currency: one unit equal to one thousand units of old currency. †German mark replaced by the euro.
Source: International Monetary Fund.

lost value against the Brazilian currency, which in earlier years had been extremely unstable. However, the pound recovered fairly quickly.

With the severe fluctuations in exchange rates in the 1970s and 1980s, foreign currency translation became a very hot topic, but with the relative stability of the 1990s, interest declined. Recent fluctuations in currency have not been so controversial for accounting as fluctuations in fair values of financial assets.

In 1999, 12 member states of the European Union agreed to set up a currency union, with the euro as the common currency. Since then, seven further countries have joined. At the time of writing, the countries in the euro currency zone are Austria, Belgium, Cyprus, Estonia, France, Finland, Germany, Greece, Italy, Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. The consequence is that, for many companies of continental Europe, foreign currency translation is no longer a problem as long as they have dealings only with companies in the eurozone.

The fact that exchange rates fluctuate creates two problems for the accountant:

1 What is the appropriate rate to use when translating an asset/liability denominated in a foreign currency, particularly if it was bought many years ago?
2 How should one account for the gain or loss that arises when exchange rates change?

To illustrate these two problems, the above example of the $100 bill will be further developed by adding that the British company acquired it on 31 December 2007, when the exchange rate was £1 = $2, and still held it on 31 December 2008, when the exchange rate was £1 = $1.46. When considering what exchange rate to use to translate the $100 bill, for the purpose of including this asset in the balance sheet at 31 December 2008, two possible rates suggest themselves:

- *The exchange rate at the time when the $100 was acquired*. Using the exchange rate of £1 = $2 gives a translated value of £50, which is, in effect, the historical cost of the asset in terms of pounds. The exchange rate at a past date is known as the 'historical rate'.
- *The exchange rate at the balance sheet date*. Using the rate of £1 = $1.46 gives a translated value of £68.49, which is, in effect, the current value of the asset at 31 December 2008. The exchange rate at the balance sheet date is known as the 'closing rate'.

When the historical rate is used for translation, the asset's value in terms of pounds is frozen at the time of acquisition. In the above example, the dollar bill would be valued at £50 on 31 December 2007 when it was acquired, and this would not alter. However, when the closing rate is used, the translated value varies over time. On 31 December 2007 the dollar bill is valued at £50 but on 31 December 2008 at £68.49. This increase of £18.49 is caused solely by the process of translation as the dollar value of the asset is unchanged. Obviously, this can have a major effect on the balance sheet.

The other part of the double entry is the 'gain/loss on translation', which has to be recognized somewhere in the financial statements; a problem considered in Section 17.9.

17.1.3 Translation of transactions versus translation of financial statements

The accountant is faced with the problem of translation in two broad areas:

1 *The translation of transactions*: the treatment of transactions denominated in foreign currency in the financial statements of an individual company.
2 *The translation of financial statements*: the preparation of the consolidated financial statements of a group, where the financial statements of subsidiaries are denominated in different currencies from the group's statements.

Most of this chapter concerns the second problem: translation of financial statements, for three reasons. First, it is very important in material terms: the amounts involved can run into millions of dollars or euros. Secondly, historically, much attention has been given to this area, as will be apparent when historical developments are considered later. Thirdly (and the most compelling reason for the author), the fact that there are several fundamentally different ways of translating financial statements gives rise to a fascinating area of theoretical and empirical study, to which this chapter is only an introduction.

17.2 Translation of transactions

17.2.1 The issue

As explained in the previous section, the translation of transactions concerns the treatment of foreign currency transactions in the accounting records and the financial statements of the individual company, which are usually denominated in the company's home currency. Therefore, before a foreign currency transaction can be recorded, it must first be translated. The practical necessity of recording transactions on a daily basis means that a foreign currency transaction is translated at the exchange rate ruling when it is recognized and recorded.

Translation at that exchange rate is also consistent with general valuation principles of historical cost accounting – that is, historical cost in terms of home currency. For example, a machine purchased in foreign currency is entered in the accounting records at its historical cost in terms of home currency. All subsequent adjustments to this figure follow the normal rules of accounting, e.g. systematic depreciation in the case of the machine. In effect, the fact that the assets were acquired by an outlay of foreign currency is no longer relevant, once the assets have been recorded in the accounting records in terms of home currency. However, this conclusion is not so obvious for an asset held at fair value (e.g. an investment property or a holding of equity shares) nor for monetary assets and liabilities.

For monetary items denominated in a foreign currency, the historical cost in terms of home currency might not be the appropriate value when a balance sheet is drawn up at a later date. In principle, one can conceive of three different ways in which such assets and liabilities might be translated:

1 *At the historical rate*. With this method, the home currency amount of these items is left unchanged and no translation gain or loss is reported.

2 *At the balance sheet (closing) rate*. This gives the current value of these items in terms of home currency, i.e. the amount of money that would be received (or paid) on the balance sheet date if the monetary asset (or liability) were to be converted into home currency. The double entry for the difference in values is a gain or loss (see discussion of its treatment below).
3 *At the lower (higher) of the historical rate and the closing rate for assets (liabilities)*. When this method is used, assets are stated at the lower of two possible values and liabilities at the higher. This means that losses on translation but not gains can arise; the closing rate is only used if it gives rise to a loss.

Of the three methods, the first is not used in practice. Some accountants might justify its application on the grounds that, in a period of fluctuating exchange rates, the historical rate is as good a guide as the closing rate to the rate at which the debtor or creditor will be settled. Particularly in respect of long-term monetary assets and liabilities, it might be considered premature to report a gain or loss arising from a fluctuation in exchange rates, which may be reversed in a future period. However, in the author's opinion, this argument is invalid. It is contrary to basic accounting principles to report monetary assets at higher than their current values and liabilities at lower than their current values.

However, there are good arguments for both the second and the third methods. In old-fashioned terms, the second method is based on the 'accruals principle' and the third on the 'prudence principle', as will now be explained.

17.2.2 Prudence versus accruals

The prudence principle

The prudence principle could be seen as a necessary check on the optimism of management, which is always trying to present the results of its endeavours in the best possible light. For the consolidated statements of listed companies, this often means attempting to increase profit. This will be illustrated with an example, the calculations for which are given in Table 17.2. On 31 December 1995, a British company borrowed $1,000 repayable on 31 December 2010. The liability was initially recorded at £645, using the exchange rate at 31 December 1995. A year later, at 31 December 1996, the value of the loan at the closing rate was £588. Should the company take credit for a gain of £57 arising from the fall in value of the liability? When one considers the subsequent fluctuations in the pound/dollar exchange rate, it might seem premature to report any gain.

Table 17.2 Example based on the prudence principle

Translated value of $1,000
31 December 1995 $1,000 × £1/$1.55 = £645
31 December 1996 $1,000 × £1/$1.70 = £588
31 December 2010 $1,000 × £1/$1.54 = £649

In the succeeding years, the pound fell against the dollar, leading to an increase in the value of the liability in terms of pounds. In fact, when the loan was finally repaid on 31 December 2010, the pound had fallen below its 1995 value, so that overall a loss of £4 was made on the loan. Some accountants might claim that the translation gain calculated for 1996 should not be regarded as realized at that point. If the 1996 'gain' had been distributed to shareholders, the company would subsequently have been obliged to ask for its money back if it had wanted to maintain its capital.

The accruals principle

The IASB *Framework* explains that the accruals principle:

> depicts the effects of transactions and other events and circumstances . . . in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. (paragraph OB17)

If this principle is followed, the accountant should not wait until the foreign monetary asset or liability has been turned into cash (in home currency) before recognizing the change in its value. Provided that there is objective evidence of the current value (given by the exchange rate quoted on the market) the accountant should recognize the changed value now. The loss or gain that arises from the recognition of the current value relates to the current period because it was caused by the change in exchange rates that occurred during that period. It does not relate to the future period when the monetary asset or liability will be liquidated. Another way of looking at this, without the need for reference to accruals, is that monetary items should be shown at fair value. There is no difficulty in measuring in this case, and it is the most relevant value for any decisions.

An example is given in Table 17.3. On 31 December 1990, a British company borrowed one million Brazilian cruzeiros. At 31 December 2010 the loan was still outstanding and had to be reported as a liability in the company's balance sheet. Translation at the historical rate gives a value of £2,929; the translated value at the closing rate in 2009 is only £0.39 (because Brazilian currency had been adjusted by 1000 twice). The £0.39 is the amount that it would cost if the loan were to be paid off at that date. There can be no doubt that £0.39 is the better measure of the burden of the liability in 2010. Given the continuous fall in the exchange value of the cruzeiro/real, year after year, there is no reasonable chance that it will ever in the future regain its 1990 value.

Table 17.3 Example based on the accruals principle

31 December 1990:	British company borrowed one million Brazilian cruzeiros. Translated value at exchange rate current at that date: $1{,}000{,}000\text{Cr} \times \frac{£1}{341.37\text{Cr}} = £2{,}929$
31 December 2010:	Translated value at closing rate: $1{,}000{,}000\text{Cr} \times \frac{£1}{2.91\text{Cr} \times 1{,}000 \times 1{,}000} = £0.34$

17.2.3 The translation of transactions: rules and practice

Both of the above two methods are rationally based on (different) accounting principles. The author's view is that there is something to be said for both methods. However, the method based on the accruals principle gives the more relevant information.

As explained more fully elsewhere in this book (see, particularly, Chapters 5 and 12), there are three principal sources of the rules that govern the financial reporting of the world's companies:

1 IFRS provides the rules, at least for consolidated statements, for the major companies of the European Union and in many other countries that are important in international trade (see Chapter 5).
2 US GAAP provides the rules for major US companies.
3 Other national GAAPs govern the financial reporting of companies in many other countries. For example, in the European Union, the single entity financial statements (the 'individual accounts') of companies are mostly prepared under national rules, which have to comply with EU Directives.

In respect of the translation of transactions, there has, historically, been some agreement on the basic principles. This is in sharp contrast to the position with respect to translation of financial statements, which is dealt with later in this chapter. For transactions, all the GAAPs endorse the basic principle (set out in Section 17.2.1 above). That is, a transaction denominated in foreign currency is recorded in the 'home' currency at the exchange rate ruling at the time that the transaction is recognized. The main differences concern the subsequent reporting of monetary assets and liabilities, notably the exchange rate to be used and the reporting of any translation difference following a change in exchange rates, as now explained.

Monetary assets: the exchange rate

Both IFRS and US GAAP require that monetary assets denominated in a foreign currency should be translated at the closing rate at the balance sheet date. The relevant standards are IAS 21, *The effects of changes in foreign exchange rates* and SFAS 52, *Foreign currency translation* (now Accounting Standards Codification 830–20).

With regard to the national rules of EU countries, the EU's Directives lay down no specific rules relating to translation. Consequently national regulators have considerable discretion in setting the rules, especially as the Directives include both the accruals principle and the prudence principle. Given the conflict between these two principles (as outlined in the previous section) it is not surprising there is variety of national rules and practice.

In most EU countries, the national rules require that monetary assets be translated at the closing rate. The justification for this treatment was set out very clearly in the following statement by the British standard-setter:[1]

> In order to give a true and fair view of results, exchange gains and losses on . . . monetary items should normally be reported as part of the profit or loss of the period in accordance

[1]Paragraph 10 of the British standard, SSAP 20, now replaced by FRS 102.

> with the accruals concept of accounting; treatment of the items on a simple cash movement basis would be inconsistent with that concept. Exchange gains on unsettled transactions can be determined at the balance sheet date no less objectively than exchange losses; deferring the gain whilst recognizing the losses would not only be illogical by denying in effect that any favourable movement in exchange rates has occurred but would also inhibit fair measurement of the performance of the enterprise in the year.

This favours the accruals principle over the prudence principle. However, in Germany, the rules require that non-current monetary assets be translated at the lower of the historical rate and the closing rate, giving the lower of the two possible values for the asset. Liabilities are translated at the higher of the two rates. This leads to a prudent valuation (assets should not be overstated, liabilities should not be understated) and avoids reporting an unrealized profit. However, another motivation is the desire of companies to delay payment of tax until the foreign currency item has been realized, given that, in Germany, the amount of tax that a company pays is computed on the profits reported in its unconsolidated financial statements. Since listed companies are required (and others are allowed) to apply IFRS for their consolidated statements, they apply the prudent German rules only in their individual statements.

An example of this is drawn from the 2014 annual report (page 40) of the parent company of BASF, the chemical company headquartered in Germany:

> Current foreign-currency receivables and liabilities are valued at the average spot currency exchange rates on the balance sheet date. Noncurrent foreign-currency receivables are recorded at the rate prevailing on the acquisition date or at the rate on the balance sheet date if lower. Noncurrent foreign-currency liabilities are recorded at the rate prevailing on the acquisition date or at the rate on the balance sheet date if higher.

The location of any translation gain

Under any of the above rules, translation losses are reported as part of profit or loss, i.e. in the first part of a statement of comprehensive income. However, the location of any gains varies. IFRS and US GAAP are in accord that gains must also be in profit or loss, but in some European countries gains on translation are deferred and only transferred to income when settled. A survey of European companies, which is reported in Ebbers (1997), indicates that deferral occurred in most EU countries in some companies and that, in France, Spain, Italy and Belgium, a majority of companies deferred. It must be emphasized that this practice is now permitted only in the financial statements of non-listed companies and the individual statements of listed companies.

An example of this is drawn from the 2014 annual report of the parent company of L'Oréal, the French cosmetics company:

> Translation differences on operating assets and liabilities and related hedging instruments are recognised in the balance sheet as *Unrealised exchange losses* or *Unrealised exchange gains*. A provision is recognised if the sum of these unrealised exchange gains and losses shows a potential exchange loss based on the overall exchange position of all currencies taken together.

The postponed gain is shown in the balance sheet as a sort of liability, although of course it does not meet the IFRS definition of a liability because there is no obligation or expected outflow. Similarly, a postponed loss is shown as an asset, although there is also a provision for the loss is also charged, as L'Oréal says.

Exceptions to the general rules

The general rules that have just been outlined have been subject to a number of exceptions in the past, of which two are of particular importance: hedging and non-current assets financed through a foreign currency loan.

- **(a)** *Hedging*. Where a foreign currency receivable or payable is hedged through a forward contract, it has sometimes been translated using the exchange rate specified in the contract and not the closing rate. However, US GAAP and IAS 39 (or IFRS 9) specify a different treatment: the foreign currency monetary item should be translated at the closing rate and the forward contract reported at fair value, with all value changes reflected in current income. Both treatments will have the same effect of reporting no significant net gain or loss in respect of a foreign currency debtor or creditor that is hedged by a forward contract.
- **(b)** *Non-current assets financed through a foreign currency loan*. Where a non-current asset has been financed through a foreign currency loan, it has been the practice in some countries to capitalize any translation loss on the loan as part of the acquisition cost of the fixed asset. In this way, no loss is reported in the income statement. However, this treatment is not permitted in the USA, and, in 2003, the IASB revised its standard so as to achieve convergence with the USA. Hence, capitalization of translation losses is now only permitted by the national rules in a few countries, notably Spain and Italy.

This brief introduction to the subject of translation of transactions does not deal with all the complications that may arise. For more information on this topic, readers should consult the further reading suggested at the end of this chapter. The rest of this chapter is devoted to the translation of financial statements.

17.3 Introduction to the translation of financial statements

17.3.1 The problem

As already mentioned, the need for translation of financial statements arises when a company owns an interest in an entity that draws up its financial statements in a foreign currency. Typically this entity will be located in a foreign country.

Multinational groups are exceedingly common: virtually all major companies have foreign subsidiaries. Their special problem of consolidation is that the component financial statements of the group are denominated in different currencies. To prepare the consolidated balance sheet of a group consisting of a British parent company and its US subsidiary, the two balance sheets must be denominated in the same currency. One cannot add together the parent company's assets valued in terms of pounds and the subsidiary company's assets valued in terms of dollars – one of the currencies must be changed. It is normal to denominate consolidated financial statements in the currency of the parent company, as the main users of the consolidated statements are the shareholders and the creditors of the parent company who are usually based in the parent's country. Therefore, in this case, it is the financial statements of the subsidiary that are translated from dollars to pounds. The pound in this case is the 'presentation currency'. A few British companies choose the dollar or the euro as their presentation currency. The methods used by accountants to achieve translation will now be considered.

17.3.2 The three traditional translation methods before 1975

In practice, assets and liabilities of foreign subsidiaries are translated using either the historical rate or the closing rate. However, when the IASC and the FASB were founded in 1973, there was no basic agreement as to which rate should be used to translate which items. Three different translation methods were in widespread use:

1. the current rate method, which used the closing rate for all assets and liabilities;
2. the current/non-current (CNC) method, which used the closing rate for current assets and current liabilities, and the historical rate for all other assets and liabilities;
3. the monetary/non-monetary (MNM) method, which used the closing rate for monetary items (i.e. money and amounts to be received or paid in money – receivables, payables, loans, etc.) and the historical rate for non-monetary items (i.e. most non-current assets and inventory).

Method 1 is called 'current rate' here (rather than 'closing rate') because some of the versions of it do not use the closing rate for items in the foreign income statement and cash flow statement. As will be seen, both IFRS and US GAAP require rates ruling on the dates of transactions, although in practice an average for the period is often used. Hence the rates are 'current' for the appropriate transactions and balances.

17.3.3 An example

The application of these three methods is illustrated with a simple example, which uses the rates of exchange of the 1970s. On 31 December 1976, the German subsidiary of an American company acquired the assets and liabilities listed in the first column of Table 17.4. To ease the exposition, it is assumed that no transactions took place in the following year, so that the subsidiary's balance sheet in terms of local currency (at the time, Deutsche Marks) at 31 December 1977 (drawn up in accordance with the historical cost convention) is identical to that of a year earlier. Table 17.4 shows how the subsidiary's balance sheet is translated into dollars using each of the three methods described above.

The net assets of the subsidiary at 31 December 1976 were $8,400. There is no dispute over this figure. As all the assets and liabilities were acquired on 31 December 1976, the closing rate and the historical rate at that date are the same. However, the three methods give widely differing figures for the subsidiary's net assets in dollars at 31 December 1977: current rate method, $10,000; CNC method, $12,400; MNM method, minus $400. The change in the subsidiary's net assets during 1977 means that there was a gain (current rate method and CNC method) or a loss (MNM method). This gain (loss) clearly arises from the translation process, because no gain or loss is shown in the subsidiary's local currency financial statements. Therefore it is described in Table 17.4 as 'gain (loss) on translation'.

17.3.4 The translation gain/loss examined

It is startling to note the wide variations in the gain or loss on translation: a loss of $8,800 under the MNM method, compared with a gain of $1,600 under the current

Table 17.4 Example illustrating the three translation methods

	Foreign subsidiary balance sheet at 31.12.76 and 31.12.77*	Foreign subsidiary's translated balance sheet at 31 December 1977					
		Current rate method		CNC method		MNM method	
	Local currency	Exchange rate	Translated value	Exchange rate	Translated value	Exchange rate	Translated value
Fixed assets	DM100,000	CR 0.50	$50,000	HR 0.42	$42,000	HR 0.42	$42,000
Current assets							
Inventory	DM30,000	CR 0.50	$15,000	CR 0.50	$15,000	HR 0.42	$12,000
Debtors	DM20,000	CR 0.50	$10,000	CR 0.50	$10,000	CR 0.50	$10,000
Total assets	DM150,000		$75,000		$67,000		$64,000
Long-term liabilities	DM130,000	CR 0.50	$65,000	HR 0.42	$54,600	CR 0.50	$65,000
Net assets at 31.12.77	DM20,000		$10,000		$12,400		($400)
Note:							
Net assets at 31.12.76	DM20,000	0.42	$8,400	0.42	$8,400	0.42	$8,400
Translation gain/loss			$1,600		$4,000		($8,800)

Notes: Exchange rate at 31 December 1976, HR (Historical Rate) $1 = DM 0.42; at 31 December 1977, CR (Closing Rate) $1 = DM 0.50.
*No transactions in 1977.

rate method and an even bigger gain of $4,000 under the CNC method. It is instructive to examine these gains and losses a little more closely. At the start of 1977, one mark was worth $0.42, and $0.50 at the end of the year. Hence the parent company records a gain of $0.08 for every mark-denominated asset that it held during 1977. This is clearly the case where the asset involved is cash (e.g. a one mark coin). However, where the book value in terms of marks of an asset, such as plant or inventory, remains constant over the year in accordance with accounting convention, then the exchange rate change will lead to the recording of a dollar gain in respect of this asset. In the same way a loss of $0.08 will be recorded for each mark owed.

Table 17.5 explains how this gain or loss arises under each of the three translation methods:

1 Under the current rate method, all the assets and liabilities are revalued at 31 December 1977 using the new closing rate. Hence the gain is calculated on the whole of the holding company's net investment in the subsidiary.
2 Under the CNC method, the non-current assets and liabilities, being translated at historical rates, retain their original value in terms of dollars. Hence, no translation gain is recorded in respect of these assets and liabilities. The gain is recognized only in respect of current assets and liabilities.

Table 17.5 Net gains and losses on translation

Method of translation	Assets/liabilities subject to translation gain (loss)	Amount of relevant net assets	Gain (loss) per DM of net assets	Net gain (loss)
Current rate	All assets/liabilities	+DM 20,000	$0.08	$1,600
CNC	Current assets/liabilities	+DM 50,000	$0.08	$4,000
MNM	Monetary assets/liabilities	–DM 110,000	$0.08	($8,800)

3 In the case of the MNM method, a similar principle is followed: the gain is calculated only on the monetary items. Because, in this example, the net monetary assets are negative (the liabilities exceed the monetary assets), a loss is reported.

The three methods produce widely differing figures for the translation loss because of different assumptions as to which classes of assets and liabilities are affected by changes in exchange rates.

17.4 The US initiative in the 1970s

17.4.1 The temporal method

The existence of these three methods of translation, which produced such widely different results, was disturbing. Clearly not all three methods could be correct for the same purpose.

The Americans were the first to do something about the problem. The American Institute of Certified Public Accountants commissioned a member of its research staff, Leonard Lorensen, to undertake a thorough study (Lorensen, 1972). This was one of the best pieces of academic research applied to a major practical problem in accounting; and one of the most influential. The report established and clearly set out a universally applicable 'temporal method'. Under historical cost accounting this turns out to be very similar to the MNM method.

The essence of the temporal method is that the valuation methods used for the subsidiary's assets and liabilities in its own balance sheet should be retained in the translated financial statements. There are several different methods used in valuing assets in the balance sheet. They may be classified as follows:

1 Historical cost: the amount of cash (or resources of equivalent value) actually paid out in the past in order to acquire the asset.
2 Current replacement cost (CRC): the amount of cash that would have to be expended by the company at the balance sheet date to acquire a similar asset.
3 Fair value or net realizable value (NRV): the amount of cash that the company would receive if it were to sell the asset at the balance sheet date; in the case of NRV, this is net of expenses.

4 Value of future receipts (discounted or not): receivables are stated at the amount of cash that the company expects to receive in the future. Similarly, payables and other liabilities are stated at the amount of cash that the company expects to be obliged to pay out in the future. Value in use is calculated as discounted cash flows.

For each of these four types of valuation, a particular date pertains to the money amount at which a subsidiary's asset is valued, and this shows the exchange rate to be used in its translation. Lorensen did not consider fair value or value in use, because they were not used in US standards at the time. Lorensen's conclusions, updated, are:

1 historical cost: the date of the acquisition of the asset, hence, the historical rate is appropriate;

2 **and 3** CRC, fair value and NRV: the balance sheet date, hence the closing rate;

4 value of future receipts: the future date on which the asset or liability will be converted into cash, hence, the future rate.

Despite the apparent logic of number 4 above, Lorensen came to the conclusion that the closing rate, and not the future rate, should be used for the translation of assets (liabilities) valued at the amount of future receipts (payments). There are a number of reasons for this decision – some pragmatic, some more theoretical. The appropriate future rate is often not known when the balance sheet is being prepared, and the best (or at least the most objective) estimate of it is the closing rate. Furthermore, if a future (or forward) rate is quoted on the foreign exchange market, which is different from the current (or spot) rate, the difference between the two rates will normally be offset by differences in interest rates; that is, interest rates will be higher in a country where the forward rate is lower than the spot rate (see the discussion on the 'Fisher effect' in Section 17.10.2). In order for interest charges to be allocated to the right period, the closing rate should be used to translate loans. If the future rate were used, interest would be anticipated. For example, a company could record instant profits simply by investing in bonds denominated in a currency whose forward rate stood at a premium in relation to its spot rate. Finally, if there were a change in exchange rates between the balance sheet date and the date when the debt or liability were liquidated, it can be argued that the gain (or loss) would be caused by an event of the later period (i.e. when the rate changes) and should be recorded in that period. For all these reasons, the closing rate and not the future rate is used in the application of the temporal method.

For value in use, the closing rate would make sense because discounting reduces the flows to a present value.

17.4.2 The generalizability of the temporal method

The temporal method generally arrives at the same results as the MNM under historical cost accounting. With the temporal method, assets measured on a current or future basis (including monetary assets) are translated at closing rate, and assets that are stated at historical cost (as is generally the case with non-monetary assets) are translated at historical rates. The main difference is that under MNM any inventories measured at NRV would be translated at a historical rate. However, the beauty of the temporal principle is that it is not tied to the historical cost convention. It provides the rules for the translation of financial statements prepared in accordance with

other valuation conventions. Thus, if certain of the subsidiary's assets are valued at fair value, then clearly the closing rate should be used.

A further justification of the temporal method is that it ensures that a company reports identical numbers for assets and liabilities irrespective of the method that it uses to finance a foreign operation: whether directly or through a subsidiary. Consider the example of a British company that plans to acquire some land in the United States. It could purchase the land directly without using a US subsidiary, transferring funds to the US for the purpose. Using the rules for the translation of transactions as set out in Section 17.2, the British company would then report the land as an asset in its own balance sheet, stated at the dollar cost translated into pounds at the exchange rate ruling when the land was acquired, which would be the amount of cash sent from the UK unless there had been a delay during which exchange rates had changed. Alternatively, the British company could acquire the land through a subsidiary registered in the USA. The subsidiary would maintain its accounting records and draw up its financial statements in dollars: at the end of the year these financial statements would be translated into pounds using the temporal method. The value reported for the land in the British company's statements[2] would be the same irrespective of the method used to acquire it. For example, if the dollar fell in value, this would have no effect on the balance sheet, whichever method of purchase had been used. Hence, the temporal method respects one of the fundamental principles of financial reporting, that transactions that are essentially similar should be reported in a similar fashion. By contrast, if the dollar fell in value and the closing rate were used, then the land would fall in pounds under the group way of purchasing but not under the direct way of purchasing.

It is the general applicability of the temporal principle that makes it so attractive to many accounting theorists and that has convinced them, on essentially *a priori* grounds, that it provides the correct solution to the translation problem.

17.4.3 SFAS 8

The FASB accepted the recommendations of the Lorensen Study with few reservations. In October 1975 it issued *Statement of Financial Accounting Standards No. 8* (FASB, 1975), which made the use of the temporal method obligatory for financial statements relating to accounting years beginning on or after 1 January 1976. This caused a furore, particularly from companies that found themselves obliged to report substantial losses on translation in their consolidated statements. Under the terms of SFAS 8, these losses were a charge against consolidated profits and thus reduced earnings per share. In the mid-1970s the dollar weakened against many major currencies, such as the yen, the mark and the pound. With the application of the temporal method, American multinationals were obliged to report translation losses on foreign currency borrowings (even long-term borrowings), while no translation gain could be reported in respect of the foreign non-current assets that had been acquired with the proceeds of the borrowings. Under other translation methods, no such net loss is reported: under the CNC method, no gain or loss is reported on either the assets or the liabilities; under

[2]The individual statements if the land is acquired directly by the British company and the consolidated statements if it is acquired through a subsidiary.

the current rate method, the gain on the assets offsets the loss on the liabilities. This point is illustrated in Table 17.4; in 1977 the US dollar lost value against the mark, which resulted in the reporting of a substantial translation loss under MNM, which would be identical under the temporal method.

Thus, after 1975, there began a spirited public debate over the temporal method, that started in the United States and spread to the rest of the world. This is the subject of an excellent article by Nobes (1980). In this debate it was soon agreed by most parties that the CNC method should be rejected, and thus the issue was reduced to a straight contest between the temporal method and the current rate method.

17.5 The temporal method versus the current rate method

17.5.1 An outline of the arguments

The opposition between the temporal method and the current rate method throughout the accountancy world was the most important aspect of the translation problem. Note, however, that this opposition would not arise if all assets and liabilities were measured at fair value, when the two methods would give the same results. It is the author's opinion that, for the reasons set out in Section 17.4.2, only the temporal method can be justified for use with historical cost accounting. The fundamental objection of the accounting theorist to the closing rate method under historical cost accounting can be stated very simply. The current rate method, when applied to an asset stated in the foreign subsidiary's balance sheet at historical cost, produces a translated figure that has no meaning: it is not the historical cost in terms of the home currency; neither is it the fair value, the CRC or the NRV: 'The number is in fact nothing except the product of multiplying two unrelated numbers' (Lorensen, 1972, page 107). The leading German theorist, Büsse von Colbe, made the same point more politely: 'translation of historical costs, expressed in foreign currency, at the current rate does not result in a valuation that can be interpreted in any meaningful sense' (Gray *et al.*, 1993, page 327).

The case for the current rate method (referred to as the 'closing rate' method in the quotation below) was set out by the UK's ASC (ASC, 1977), notably paragraphs 9 and 10:

> 9 The closing rate method is based on the concept that a reporting company has a net investment in a foreign operation and what is at risk from currency fluctuations is the net investment . . .
>
> 10 The closing rate method possesses the following advantages:
>
> (a) It deals effectively with the situation where fixed assets located overseas have been financed by foreign currency borrowings and a change in the exchange rate results in offsetting gains and losses.
>
> (b) The relationship existing between balances in accounts as originally prepared in a foreign currency is preserved in the translated accounts, whereas this is not the case where historical rates are used for translating certain assets.

17.5.2 Preservation of relationships in the subsidiary's financial statements

Paragraph 10(b) from the above quotation refers to an interesting and somewhat disturbing aspect of the temporal method, namely that the process of translation can change the relationship between individual items in a financial statement. This arises because different exchange rates are used to translate different items: the historical rate is used for non-current assets and the closing rate for most other items. Thus the relative weight of non-current assets in the translated balance sheet will be different from that shown in the subsidiary's foreign currency balance sheet. This will affect, among other matters, the debt/equity ratio. More significantly, in the translated income statement, the weight given to depreciation (derived from non-current assets translated at a historical rate) will be different from that shown in the foreign currency statements. If the foreign currency has fallen in value (relative to the home currency) since the assets were acquired, this will have the effect of increasing the relative importance of the depreciation expense in the translated income statement. This could well turn a profit reported in the subsidiary's foreign currency statements into a loss in the translated statements. This point is demonstrated in Table 17.6, using examples of exchange rates.

There are other circumstances in which a profit may be translated as a loss, notably when there have been significant changes in both exchange rates and profits over the year. For example, a subsidiary records a loss in the first half of the year, followed by a bigger profit in the second half, giving a profit for the whole year. In the translated statements, if the loss is translated at a more favourable exchange rate than that applied to the profit, it could make the translated loss larger than the translated profit, giving a loss for the whole year.

Table 17.6 Example of how the temporal method translates a profit as a loss

	Foreign currency statements ($)	Translation factor	Translated statements (£)
Income statement for 200X4			
Trading profit	105,000	£1/$1.70	61,765
Less depreciation	100,000	£1/$1.55	64,516
Net profit/(loss)	5,000		(2,751)
Balance sheet at 31 December 20X4			
Fixed assets: costs	1,000,000	£1/$1.55	645,161
less depreciation	100,000	£1/$1.55	64,516
	900,000		580,645
Current assets (cash)	200,000	£1/$1.70	117,647
Total assets	1,100,000		698,292
Less long-term liabilities	500,000	£1/$1.70	294,118
Net worth (equity)	600,000		404,174
Note: Debt/equity ratio =	1:1.20		1:1.37

Data: The foreign subsidiary bought all its fixed assets at 1.1.20X0.
All transactions assumed to take place at year end.
Exchange rates: 1 January 20X0 £1 = $1.55; throughout 20X4 £1 = $1.70.

To proponents of the temporal method, this is a highly awkward result and they need all their ingenuity to explain how it is right for a profit in one currency to be turned into a loss when translated into another currency. However, there are good arguments to be made. First, it should be stressed that the purpose of translation is to permit the preparation of consolidated financial statements. As a general rule, the translated figures of the subsidiary's assets, liabilities, revenues and expenses are aggregated with those of the parent company in the consolidated statements; the foreign subsidiary's separate entity is lost in the consolidated statements. Hence, the fact that it has a certain debt/equity ratio as an individual company is irrelevant from the viewpoint of the consolidated financial statements. Conversely, if a user (e.g. a non-controlling (minority) shareholder or a creditor of the subsidiary) wishes to examine the financial position of the foreign subsidiary as a separate entity, then he or she should look to its separate local currency statements; the group statements are irrelevant for this purpose. The creditor of a subsidiary company cannot normally demand repayment of the debt from the parent company, nor can a minority shareholder expect dividends to be paid out of group profits.

However, while the above argument goes part of the way towards explaining why the relationships in the subsidiary's financial statements are irrelevant for the consolidated statements, it is still uncomfortable that a profit in the subsidiary's own (local currency) income statement can be translated into a loss in the consolidated statement. One may legitimately ask the question: which financial statement provides the fair presentation – the subsidiary's statement or the translated version incorporated into the consolidated statement? If the temporal method is correct, then the answer to this question must be that both financial statements are fair. The subsidiary's own financial statements are fair for its shareholders and creditors; the consolidated financial statements (incorporating the subsidiary's translated statements) are fair for the shareholders of the parent company. How is this possible?

It will be recalled that a profit can be translated into a loss only when certain assets (i.e. non-current assets and inventory) are valued in the balance sheet at historical cost. When this convention is followed the users of the statements should interpret the book value of the assets as being the amount of finance that is tied up in these assets, expressed in terms of the currency in which the finance was provided. In the case of a parent company owning foreign assets via a subsidiary, ultimately the assets have been financed by the parent company's shareholders. When the assets were acquired, these shareholders made a financial sacrifice. This is the justification for stating the subsidiary's assets in the consolidated financial statements at their historical cost in terms of the parent currency. Their sacrifice was in terms of their own currency. When, subsequently, the local currency falls in value relative to the parent currency, then the revenue-generating capacity falls (in parent currency terms), but the wearing out of the asset costs the same as before. Thus, even operating profits can disappear.

In addition, part of the capital contributed by the parent company's shareholders is lost; and this creates another sort of loss, as discussed in Section 17.8.

To summarize, the response to the ASC's paragraph 10(b) is, first, that the relationships in the foreign subsidiary's financial statements are largely irrelevant for the consolidated financial statements. Secondly, where they are relevant, the relationship produced by the application of the temporal method is the correct one from the viewpoint of the shareholders of the parent company.

Finally, the *coup de grâce*: the current rate method suffers from the same problem as the temporal method, in that it can also turn an operating profit into a translated loss. This is because actual or average rates are used for the translation of the income statement under the current rate method. Hence, in the example given in this subsection of a subsidiary that reported a loss in the first half of the year and a profit in the second half, the current rate method would also translate an annual profit as an annual loss.

17.5.3 The net investment concept

Next, the ASC's paragraph 10(a) has to be considered. This is closely tied up with the statement in ASC paragraph 9 (see earlier quotation) that the current rate method is based on the concept that a reporting company has a net investment in a foreign operation and what is at risk from currency fluctuations is that net investment. This statement is rather brief. The full line of reasoning can be presented as follows:

1. In many cases, in practice, foreign subsidiaries are largely autonomous; decisions as to which assets to acquire or hold, and on trading operations, are taken by the local board of directors.
2. Additionally, these foreign subsidiaries are often largely self-financing, using local loans and retained profits.
3. In these circumstances, the parent company's main interest in the subsidiary is the annual dividend. If this is satisfactory, the parent company will not concern itself in detail with the subsidiary's financial position or operations.
4. Hence, the parent company is not interested in the detailed assets, liabilities, income and expenses of the subsidiary; its interest is in the net investment in the subsidiary that is the source of the only tangible benefit, the annual dividends.
5. The value of this net investment is best reflected in translating the net assets at the closing rate.
6. As the net assets are to be translated at the closing rate, all the other items in the balance sheet must be translated at the same rate if the balance sheet is to balance.

This line of reasoning appears very strong when one considers the case of a devaluation of the home currency, as demonstrated in the example in Table 17.4. In the normal situation of a foreign subsidiary with net monetary liabilities (i.e. total liabilities exceeding monetary assets), the application of the temporal method will lead to a fall in the value of the subsidiary's translated net assets, because the translated value of the non-current assets will remain unchanged but the translated value of net liabilities will increase. This hardly seems logical. After the devaluation, the foreign currency is worth more in terms of the home currency than before; the net investment that is expressed in terms of the foreign currency should also be worth more. An alternative argument is that, following the devaluation, the annual dividend from the subsidiary will probably be worth more in terms of the home currency. This will certainly be the case if there is no change in the annual dividend in terms of the foreign currency. The net investment in the foreign subsidiary, the source of these dividends, should therefore be worth more on the principle of an investment being

valued as the net present value of future receipts. This is essentially the case set out in paragraph 10(a).

This argument appears both logical and coherent. However, the above line of argument falls down in two places. First, the method of valuation that is appropriate for the net assets is not necessarily appropriate for each of the individual assets and liabilities: this line of reasoning leads directly to the nonsense of the historical cost of an asset being translated at the closing rate. Secondly, if a subsidiary is really an independent entity, then it is not appropriate to consolidate fully this subsidiary in the group's consolidated statements.

The IASB defines consolidated financial statements as those of a group 'presented as those of a single economic entity'.[3] The EU's Seventh Directive (Art. 24) states that 'the consolidated financial statements shall show the assets, liabilities, financial positions, profits or losses of the undertakings included in a consolidation as if they were a single undertaking'. The use of the terms 'single economic entity' and 'single undertaking' is very significant. It is clear that the existence of a single entity is a precondition for the preparation of consolidated financial statements. This suggests that the current rate method, which is based on the concept of the parent company having a net investment in a semi-autonomous foreign subsidiary, is not appropriate for the preparation of consolidated financial statements. The conclusion is inescapable:

- *either* the foreign subsidiary is largely autonomous, in which case fully consolidated statements should not be prepared (and in this case the parent company's investment in the subsidiary would normally be presented in its balance sheet as a single item – perhaps using the equity method);
- *or* the parent company and the foreign subsidiary may be considered a single entity, in which case the appropriate translation method to use is the temporal method which, as explained in Section 17.4.3, reports the transactions of subsidiaries as if they had been carried out by the parent company (that is, making no distinction between the members of the group, which is treated as a single entity).

However, although the author is personally convinced on this matter, the argument has been settled in favour of the current rate method. In December 1981 the FASB finally gave way to considerable pressure and issued a new standard, SFAS 52 (FASB, 1981), which effectively reversed SFAS 8 and prescribed the use of the current rate method under most circumstances. As will be seen later, this was followed by IFRS.

The demise of SFAS 8 was a most significant event in the history of standard setting. Leonard Lorensen had worked out the principles to be followed for foreign currency translation solely through the application of logical reasoning. However, many influential actors in the American financial community (principally preparers but also some auditors and users) objected to SFAS 8, not because it contained any logical flaw, but because they did not like the numbers that resulted from its application. They applied pressure on the FASB to change the standard and the FASB was obliged to give way. The whole incident demonstrated vividly that standard setting is essentially a political process, in which reason sometimes plays a minor part (see, also, Chapter 10).

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[3] IFRS 10, Appendix A.

17.6 Current US GAAP

Even the most convinced opponents of SFAS 8 admitted that SFAS 52 was not a very impressive document. The intellectual basis for most of its provisions is unclear, reflecting the fact that the statement was based not so much on research and reasoning as on the opinions of the preparers and users of statements. SFAS 52 was adopted by the FASB by the smallest possible majority: by four votes to three, the minority including the Chairman of the Board. In fact, the most stimulating part of the statement is the note of dissent written by the three dissenting members. However, for good or ill, SFAS 52 has for many years been the effective standard in the United States. In 2009, it was included in the FASB's codification (as Section 830), but we still refer to SFAS 52 below.

In the introduction to SFAS 52, the FASB stated (1981, page 3) that the objectives of translation are twofold:

1 to provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity; and
2 to reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with US generally accepted accounting principles.

In setting these objectives the FASB clearly had in mind the two major criticisms of the temporal method that are discussed in Section 17.5: the first objective refers to the paradox that an upward revaluation of the foreign currency may lead to a loss on translation, and the second objective refers to the paradox of a profit being translated as a loss. Therefore, even at the stage of setting the objectives the FASB appears to have made up its mind against the temporal method.

The first objective is remarkable for the proposition that financial statements should reflect *expected* economic effects. In the author's opinion, this was a revolutionary departure from the generally accepted accounting principles of the time, which were based on the principle of measuring reality as evidenced by the past (in the case of historical cost) or by the present (in the case of fair value, replacement cost or realizable value). When the second objective is analyzed more closely, it becomes clear that it is virtually identical to the imposition of the current rate method. For in order to preserve in the consolidated financial statements the results and relationships of the subsidiary's own statements, it is necessary that every item should be multiplied by the same factor (i.e. the translated statements should be a linear transformation of the foreign currency statements). If the same factor has to be used for all items, then clearly it has to be the closing rate.

Given these objectives, it was inevitable that SFAS 52 should come to the conclusion that the financial statements of foreign entities, as expressed in their 'functional currencies', must be translated at the closing rate. The new concept of 'functional currency' was given the following definition: 'an entity's functional currency is the currency of the primary economic environment in which the entity operates' (FASB, 1981, page 3). It seems clear that, for the great majority of foreign entities, the functional currency will be the local currency; for these cases, SFAS 52 provides for the straightforward application of the current rate method.

There are two main exceptions to the general imposition of the current rate method:

1 where the foreign operations are a direct and integral component or extension of the parent company's operations – in this case it is stated that the primary economic environment is that of the parent and therefore the functional currency is that of the parent;
2 where the foreign entity operates in a 'highly inflationary' economy (defined as one where prices double in three years) – in this case, SFAS 52 prescribes the completely arbitrary rule that the functional currency is to be that of the parent company.

In these exceptional cases, where the financial statements of the foreign entity are not expressed in its functional currency, they must be translated into the functional currency using the temporal method. SFAS 52 uses the term 'remeasurement' for this process, which is confusing as it is the same as other forms of translation.

Although the use of the dollar as the functional currency of a non-US subsidiary may be exceptional, it is certainly found in practice. For example, the Caterpillar company states in its 2014 annual report that:

> The functional currency for most of our Machinery, Energy and Transportation consolidated companies is the U.S. dollar. The functional currency for most of our Financial Products and affiliates accounted for under the equity method is the respective local currency.

It is unclear how a UK subsidiary of Caterpillar, which manufactures tractors in the UK and sells to UK customers can have the dollar as its functional currency. Similarly, the chemical company headquartered in Germany, BASF, in its US GAAP report (of 2004, the last before converting to IFRS) says:

> The local currency or the US dollar is the functional currency of BASF subsidiaries and jointly operated companies in North America, Japan, Korea, China, Brazil, Malaysia and Singapore. Translation therefore takes place using the current rate method . . . The euro is the functional currency for the remaining companies. Remeasurement therefore takes place using the temporal method.

The 'remaining companies' would have included European subsidiaries outside the euro area, for example, in the UK. As will be seen below, this same issue now occurs in IFRS.

Hence, SFAS 52 sometimes requires the continued use of the temporal method and, to this extent, does not resolve the problems arising from the coexistence of more than one accepted translation method. The FASB claims that it has prescribed one single translation method, namely that based on the concept of the functional currency; however, this claim should be dismissed as sophistry on the grounds that the concept of the functional currency seems to have been invented by the FASB precisely to obscure the fact that it was continuing to permit two different translation methods.

The FASB retained the temporal method for subsidiaries that are integrated with their parent to ensure that a subsidiary's assets would be reported in the consolidated balance sheet at the same amounts as these assets would be reported if they had been

acquired directly by the parent, that is, that essentially similar transactions should be reported in the same way (as argued in Section 17.4.2). Where a subsidiary is closely integrated with its parent, it is probable that direct acquisition of the assets by the parent would be a feasible alternative. Where a subsidiary is relatively independent, this would rarely be the case.

In effect, SFAS 52 is based on the principle that, in most cases, the parent company and its foreign subsidiaries should be considered as distinct and separate entities. The consolidated balance sheet is nothing more than the arithmetic sum of the balance sheets of these distinct entities, adjusted for intra-group items. Although, in order to perform the arithmetic, the balance sheets of the foreign subsidiaries must first be translated at the closing rate, in no sense does the currency of the parent company predominate over those of its subsidiaries. Essentially, all the currencies are treated as equal. SFAS 52 rejects the concepts used by the author in Section 17.5 to justify the temporal method: that the consolidated statements are prepared for the benefit of the shareholders of the parent company and should present the returns on investments in terms of the currency provided by these shareholders. The main reason for the dissent of three members of the FASB was that they did not agree with this rejection: they believed that more meaningful consolidated results were attained by measuring costs, cost recovery and exchange risk from a home currency perspective rather than from multiple functional currency perspectives.

In 1996, a group of opinion leaders in accounting (academics, regulators, professionals and analysts) were asked to identify the best and worst American accounting standards (Reither, 1998). Their rating of SFAS 52 was most interesting: 11 per cent rated it as one of the five best standards and 16 per cent as one of the five worst standards. The reasons given for these judgements are revealing. Those who rated it a good standard argued that it 'solved a complex, emotional issue in a practical manner'; those who rated it a bad standard argued that it had no conceptual basis and replaced a standard (SFAS 8) that was conceptually superior. Hence, opinion was still sharply divided on the merits of SFAS 52. At present, there is no possibility of resurrecting the approach of SFAS 8.

17.7 Current IFRS

Given the diversity of accounting practice around the world, it is not surprising that the IASC had difficulties in preparing a standard on the subject of translation. It was not until July 1983 that it published IAS 21, *Accounting for the effects of changes in foreign exchange rates*. It is no accident that this appeared after SFAS 52, for the IASC had to wait until the FASB had made up its mind. Camfferman and Zeff (2007, pages 119–23) discuss the lengthy and difficult route that led to IAS 21. The standard was clearly based on SFAS 52 and followed it on all important matters. In 2003, the IASB, the IASC's successor, revised IAS 21, making a few changes of substance and considerable changes in terminology. It is this latest version that is analyzed here.

For those who know about developments in foreign currency translation over the past forty years, the standard is puzzling. For example, the terms 'temporal method' and 'current rate method' are not mentioned and, at first sight, the standard specifies

only one translation method – in effect, the current rate method. However, in fact, the temporal method survives for some purposes. Three terms are of particular importance:

1 *functional currency*, which is defined as the currency of the primary economic environment in which an entity operates;
2 *foreign currency*, which is defined as a currency other than the functional currency of the entity;
3 *presentation currency*, which is defined as the currency in which the financial statements are presented.

A large part of the standard is taken up with the definition of functional currency. It seems clear that, for the great majority of entities, this will be the currency of the country in which they are based and carry on their business. These companies will maintain their accounting records and draw up their financial statements in this currency. If they have transactions that are denominated in the currency of another country (that is, in a foreign currency), these transactions will be translated using the standard's rules for translation of transactions, which are essentially those set out in Section 17.2, with monetary assets translated at the closing rates and all translation gains and losses reported in income statements.

However, like US GAAP, IAS 21 leaves open the possibility that the functional currency of an entity may not be that of the country in which it is based. This would occur where the entity's income and expenses are mainly influenced by another country and by that other country's currency. For example, suppose that the Chinese subsidiary of an American parent has as its main activity the sale of goods shipped to it by the parent, where the selling price is fixed in dollars by the parent and the sales proceeds are remitted back to the parent. In this case, the subsidiary's functional currency would be the American dollar. Of course, this refers *solely* to the version of its financial statements that is incorporated into the consolidated statements. The Chinese subsidiary's financial statements will normally be denominated in the Chinese currency.

In summary, the temporal method is used when it is necessary to translate financial statements *into* the functional currency (generally from the currency in which the entity keeps its accounting records). However, there will be few foreign subsidiaries whose basic financial statements are not already denominated in their functional currency. Hence the temporal method will be used only rarely. However, examples can be found. For instance, the German pharmaceutical company, Bayer, notes in its 2014 IFRS report (page 214):

> The majority of consolidated companies carry out their activities autonomously from a financial, economical and organizational point of view, and their functional currencies are therefore the respective local currencies.

The fact that only 'the majority' of companies have the foreign currency as functional tells us that some have the euro as functional, i.e. the temporal method is used.

Another pharmaceutical company headquartered in Germany, BASF, makes this even clearer in its 2014 IFRS report:

> For certain companies outside the eurozone or the U.S. dollar zone, the euro or U.S. dollar is the functional currency. In such cases the translation into the functional currency of financial statements prepared in the local currency is done according to the temporal method . . .

In its 2008 report, it had added that:

> The temporal method is therefore used to make the translation: long-term assets, excluding loans, and paid-in capital, are translated using historical rates. Other assets, liabilities and provisions are translated using year-end rates. Equity is then calculated as the balancing figure. Expenses and income are converted at monthly average rates and accumulated to year-end figures, except for those items derived from balance sheet items converted at historical rates. Assets and foreign exchange gains or losses resulting from the conversion process are reported as other operating expenses or other operating income.

Nevertheless, for the great majority of foreign subsidiaries, the functional currency will be the currency of the country in which they are based. Therefore, for consolidation, their financial statements (which are denominated in their functional currency) have to be translated into a different presentation currency (that is, the currency of the consolidated statements, which is normally the parent's currency). For this procedure IAS 21 requires the current rate method, without using that term. Hence, one can summarize that the current rate method is used to translate statements *from* the functional currency to a different presentation currency.

In recent years, as explained in Chapter 5, the IASB and the FASB have sought to remove differences between their standards by a process of convergence. The revision of IAS 21 in 2003 removed most of the differences. The major difference between IAS 21 and US GAAP concerns the translation of the financial statements of a subsidiary whose functional currency is that of a hyper-inflationary economy, defined as one in which prices double in three years (an annual inflation rate of 26 per cent). US GAAP specifies that the functional currency is to be that of the parent company (i.e. the US dollar). IAS 21 states that the subsidiary's functional currency should be determined in the normal way, but that the subsidiary's financial statements, before being translated into the presentation currency, should be restated to remove the effects of inflation in accordance with IAS 29.

17.8 Translation of comprehensive income

In order to present a complete set of consolidated statements it is necessary to translate the foreign subsidiary's comprehensive income, before including any gains or losses caused by the translation of the balance sheet (see Section 17.9). The procedure to be followed differs according to the method used to translate the balance sheet.

17.8.1 The current rate method

There has been debate about how to translate income and expenses when the current rate method is used to translate the balance sheet. When it revised IAS 21 in 2003, the IASB considered two alternative methods:

Method 1. Translation at the closing rate. This method has the advantages that it is very simple to implement and understand, that the translated financial statements are a linear transformation of the original statements because the same rate is used for both comprehensive income and the balance sheet, and that, hence, ratios involving income and balance sheet items (such as return on assets) are translated correctly.

Method 2. Translation at the date of the transactions, with the understanding that, in most cases, the average rate for the period will provide a good approximation. This method has the advantages that it provides a better representation of the value in the home currency of the foreign currency flows and that the end of year financial statements are consistent with the interim statements.

However, it has two significant disadvantages. First, the income statement is translated at a different rate (the average rate) from that used to translate the balance sheet (the closing rate). Hence ratios that compare the two statements (for example the return on assets) have a different value in the translated statements compared with the foreign currency statements.

Also when there have been significant seasonal fluctuations in the different items of income and expenditure, the average rate is no longer appropriate and the exchange rate at the date of the specific transaction should be used. In this case different rates would be used to translate the different items in the income statement and the translated income statement would not be a linear transformation of the foreign currency statement, which can lead to the anomaly (for the reasons given in section 17.5.1) of a profit being translated as a loss.

The author favours Method 1 over Method 2. With Method 1 the translated statements are always a linear transformation of the foreign currency statements which ensures that ratios are translated faithfully and the anomaly of a profit translated as a loss cannot occur.

However, contrary to the author's position, the IASB decided to adopt Method 2. IAS 21 requires that income and expenses should be translated at exchange rates at the date of the transaction, but accepts that the average rate for the period may be used, unless clearly inappropriate (for example when there have been significant fluctuations). It gave the following reason:

> This method [Method 2] results in the same amounts in the presentation [that is, translated] currency, regardless of whether the financial statements of the foreign operation are (a) first translated [using the temporal method] into the functional currency of another group entity (e.g. the parent) and then into the presentation currency [using the current rate method], or (b) translated directly into the presentation currency [using the current rate method].
>
> IAS 21, Basis for Conclusions, para. BC18
> (the explanations in square brackets have been added)

In fact, this statement is misleading, even incorrect, in two main ways:

1 The IASB statement refers to two different processes: the first requiring two successive translations and the second only one. These processes will yield the same amounts if all the rates used for the translations pertain to the same day. For example, consider the translated value of £100, which is translated into dollars in two ways: first directly and secondly by being translated into euros and then the euro amount being translated into dollars. Using the exchange rates quoted in the previous paragraph, the direct translation would give $208 (£100 = $2.08/£1); the

second translation would give €160 (£100 = €1.60/£1), which when translated into dollars would give $208 (£100 = €1.60/£1 = $2.08/€1.60), which is mathematically identical to the amount when translated directly from pounds to dollars. However, if average rates are used (as with Method 2), the identity only holds if the average is taken as the geometric mean and not the arithmetic mean (which is the more common way of expressing an average).

2 The IASB's claim that the two processes yield the same amount is correct for income and expenses that are translated using the same rates with the temporal method and the current rate Method 2; for example the average rate may be used by both methods for sales, wages and other cash expenses. However, depreciation expense is translated at the historical rate of a previous year with the temporal method and at the average rate for the current year with the current rate Method 2. Thus, for this expense item, the translated amounts will not normally be the same.

Hence, the reason that the IASB gives for preferring Method 2 over Method 1 does not stand up to scrutiny. A further problem with Method 2 is that it does not specify the rate to be used to translate the expense item 'depreciation' because it is by no means obvious that the date of the 'transaction' of depreciation is in the current year at all.

For the translation of income and expenses, as for the translation of assets and liabilities, the IASB followed closely the USA. SFAS 52 specifies the use of the exchange rate at the date when the income and expenses are recognized but, since this is generally impractical, it permits the use of an appropriate weighted average.

In the author's opinion these problems concerning the rate to be used for the income statement are a clear indictment of the lack of theoretical basis for the current rate method.

17.8.2 The temporal method

With the temporal method, it is easy to discover the principle to be followed: for each item of income and expense: the rate of exchange to be applied is that ruling at the date when the underlying transaction is recognized in the accounting records. For sales, this will normally be the date of delivery; for goods and services paid for in cash, this will be the date of payment; for goods and services obtained on credit, it will be the date when the goods or services were received as, if a balance sheet were drawn up at this date, the amount owing would be translated at the rate on that date. In theory, every transaction should be translated at its appropriate rate; in practice, a reasonably close approximation will often be obtained by using the average rate for the period, or a weighted average where there are marked seasonal fluctuations.

Two elements of expense require special attention:

1 *Depreciation*. The rate of exchange to be used for the translation of depreciation expense is clearly the same as that used for the translation of the underlying asset – that is, the historical rate for assets valued at historical cost, and the closing rate for assets valued at current value. The 'transaction' date that determines the exchange

rate is that of the original purchase of the asset: depreciation not being a transaction. This procedure is one of the main causes of the 'profit translated as a loss' paradox that was referred to in Section 17.5.1.

2 *Cost of goods sold*. The cost of goods sold will normally include an element of inventory, which should be translated at the rate of exchange appropriate for this asset.

17.9 Accounting for translation gains and losses

17.9.1 The problem

Translation gains and losses can arise in respect of both translation of transactions and translation of financial statements. In the first case, there is general agreement that the gain or loss should be reported as profit or loss, i.e. in the income statement or in the first part of a statement of comprehensive income. This is the position in both the IFRS and US GAAP. As explained in Section 17.2.3, under the national rules of a few countries, the reporting of a gain is sometimes deferred, but ultimately it will be reported as profit or loss.

The reporting of the translation differences that arise from the translation of financial statements has generated much more controversy. It might be felt that there is no problem: as income may be defined as the increase in value of net assets (ignoring any transactions with owners), it follows that, if the translated value of an asset or liability is different from its previous translated value, a gain (or loss) is automatically created that must be shown as an element of the profit for the year. The temporal method follows this reasoning and requires that all translation gains and losses be included in the income statement. This simple rule did not find favour. It was the aspect of SFAS 8 that was criticized more than any other.

Although the current rate method was introduced to alleviate what were perceived as the malign side-effects of the temporal method, it did not eliminate translation differences. When there have been wide fluctuations in exchange rates, as has been the general experience over the past decades, translation gains and losses can be very substantial under the current rate method for a group with significant foreign interests. If reported as profit or loss, they could be the largest single item in the income statement, turning a loss into a profit or vice versa. Therefore, attention has been given as to how the effects of translation gains and losses may be tempered.

17.9.2 The translation difference under the current rate method

One possible way of dealing with translation gains and losses would be to report them separately in profit or loss, for example as extraordinary items, but this approach has not been adopted anywhere.

Instead, the approach has been to exclude such gains and losses from 'profit or loss', which is the first part of a statement of comprehensive income. US GAAP and IAS 21 both specify that the gain or loss arising on translation under the current rate method should be shown as other comprehensive income. One of the main reasons for this is the idea that these amounts are not 'real' gains and losses but rather

a difference thrown up by the translation process. Hence, SFAS 52 refers to them as 'translation adjustments' and IAS 21 as 'exchange differences'.

The British standard-setter gave the following explanation for its treatment of exchange differences:[4]

> The results of an operation of a foreign enterprise are best reflected in the group profit and loss account by consolidating the net profit or loss shown in its local currency financial statements without adjustment . . . If exchange differences . . . were introduced into the profit and loss accounts, the results from trading operations, as shown in the local currency financial statements, would be distorted. Such differences may result from many factors unrelated to the trading performance or financial operations of the foreign enterprise; in particular, they do not represent or measure changes in actual or prospective cash flows. It is therefore inappropriate to regard them as profits or losses and they should be dealt with as adjustments to reserves.

The author accepts that it may well be appropriate to exclude the 'exchange difference' when assessing the performance of foreign subsidiaries, but he rejects the notion that this 'exchange difference' does not represent a genuine gain or loss to the group. Once the group has decided to place certain values on its foreign-based assets and liabilities (which it has no hesitation in including in its consolidated balance sheet as the appropriate values), it cannot deny that the gain or loss that stems automatically from this decision is also genuine.

The reasoning in SFAS 52 is much more difficult to understand, because the four members of the FASB who voted in favour of it could not agree on the nature of translation adjustments. The disagreement was set out in paragraphs 112–15 of SFAS 52. The first view is that 'the translation adjustment reflects an economic effect of exchange rate changes . . . an unrealized component of comprehensive income . . . that should be reported separately from net income'. The second view is that the translation adjustment is 'merely a mechanical by-product of the translation process'. The author has some sympathy with the first view but not with the second, which seems to imply that items may be included in the balance sheet that have no real meaning.

The amounts involved for this type of translation gain or loss can be very large. Table 17.7 shows the figures for GlaxoSmithKline, a very large UK-based pharmaceutical company. For example, in 2008, there was a gain equal to 23 per cent of the size of earnings, and in 2014 there was a loss equal to 18 per cent of the size of earnings.

Under IAS 21 or US GAAP, when a foreign subsidiary is sold, the cumulative amount of translation gain or loss relating to it should be transferred out of the reserves via OCI into profit or loss, being reported as part of the gain or loss on liquidation. This is called the 're-classification of gains'. Incidentally, this was not allowed in old the UK standard (SSAP 20) which was used by some UK companies until 2015, on the grounds that the gains or losses have already been recognized in comprehensive income (Whittington, 2005). It is also not allowed in IFRS for SMEs or the new UK GAAP based on it (FRS 102), on the grounds of simplicity.

Table 17.7 shows the amounts in the case of Glaxo, which have been reported since 2009. For example, in 2014, £219m of gains of previous years were reclassified out of OCI and into profit or loss, caused by the sale of subsidiaries in that year.

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[4]SSAP 20, paragraph 19

Table 17.7 Earnings and currency gains/losses of GlaxoSmithKline, 2008–2014, £m

	2008	2009	2010	2011	2012	2013	2014
Earnings	4,712	5,669	1,853	5,458	4,678	5,628	2,831
Foreign currency gains/losses in OCI	1,101	(194)	166	(299)	(226)	(255)	(497)
Gains/losses reclassified on sale	[no information]	(44)	(2)	(1)	0	0	(219)

17.9.3 Translation gains and losses on transactions

When a company holds a monetary asset or a liability that is denominated in a foreign currency, it will report a translation gain or loss in its individual financial statements when the exchange rate changes. If that company is a subsidiary, this translation gain or loss will be incorporated in the consolidated income statement (i.e. in profit or loss). This can lead to the reporting of some very strange gains and losses, as is illustrated in the following example for which the calculations are set out in Table 17.8.

The Dutch subsidiary of an American parent holds two assets: bank deposits of $100 and of £100. It reports euro translation gains on its holdings of dollars and pounds in its individual financial statements, which are denominated in euros. This is fully in accordance with the rules for the reporting of monetary assets that were set out in Section 17.2. When the Dutch company's income statement is translated into dollars using the current rate method for incorporation into the consolidated financial statements, these translation gains are themselves translated from euros to dollars using the average exchange rate for the year, giving translation gains of $16.70 on the dollar deposit and of $23.88 on the pound deposit. These translation gains which are reported in the consolidated income statement are very strange. The American parent reports in its consolidated income statement a gain of $16.70 in respect of the $100 that is held by a member of the group. In the author's opinion, this gain is a complete fiction; it is impossible to make a gain expressed in dollars on a holding of dollars. However, the gain of $23.88 on the holding of £100 is even more bizarre, for the pound's exchange value against the dollar fell during the year, so that, from the viewpoint of the American shareholders, the £100 was worth $10 less at the end of the year than it was at the start. It seems quite unacceptable that the group should report a gain of $23.88 in respect of an asset whose dollar value fell during the year.

It should be noted that these anomalies arise only when the current rate method is used. With the temporal method, the consolidated income statement reports no gain or loss in respect of the $100 holding, and a loss of $10 on the £100.

This example illustrates the implications of the multiple functional currencies approach, on which the current rate method is based. The Dutch subsidiary makes a gain on its holdings of dollars and pounds, when they are measured in its functional currency, the euro. The translation of this gain from euros to dollars does not change the basis of its calculation, which remains in the functional currency (the euro). It is only the presentation of this gain that has changed (from euros to dollars): hence,

Table 17.8 An example of gains and losses on monetary balances

An American company owns a Dutch subsidiary, which holds only two assets: a bank deposit of \$100 and a bank deposit of £100. Assume that, during the year 200X, there were no transactions and that the market exchange rates were:

At start of year:	£1 = €1.60 = \$2.08
At end of year:	£1 = €1.80 = \$1.98
Average for the year:	£1 = €1.70 = \$2.03

At the end of the year the Dutch company reports the following translation gains in its individual financial statements:

On the bank deposit of \$100:

Value at start:	\$100 × €1.60/\$2.08 = €76.92
Value at end:	\$100 × €1.80/\$1.98 = €90.91
Difference = gain of	€13.99

On the bank deposit of £100:

Value at start:	£100 × €1.60/£1 = €160
Value at end:	£100 × €1.80/£1 = €180
Difference = gain of	€20

These translation gains are translated into dollars using the average exchange rate and are reported in the American company's consolidated income statement at the following amounts:

Gain on bank deposit of \$100:	€13.99 × \$2.03/€1.70 = \$16.70
Gain on bank deposit of £100:	€20 × \$2.03/€1.70 = \$23.88

If the American company had held the £100 directly, it would have reported the following loss:

Value at start:	£100 × \$2.08/£1 = \$208
Value at end:	£100 × \$1.98/£1 = \$198
Difference = loss of	\$10

IAS 21's term 'presentation currency'. This is the reason why it is considered perfectly acceptable for the American group in the example to report a gain in respect of dollars – the gain has been made by its Dutch subsidiary as measured in euros and once so calculated is not changed.

In effect, in the consolidated financial statements of a multinational group that is made up of many foreign subsidiaries, the profits of each subsidiary are calculated in its functional currency. In order to prepare the consolidated statements, these profits are restated in terms of a common presentation currency. However, this does not change their basis of calculation. In the author's opinion, this presentation in a common currency is purely cosmetic. It does not change the fundamental facts that the different subsidiaries' profits are calculated in different ways and that it makes no sense to combine them. In the author's opinion, combining them by translating into a common presentation currency is the equivalent of adding together apples and oranges.

17.9.4 Translation differences on intra-group loans

IAS 21 does not deal with the anomalies exposed in the previous section, except in the special case of a loan from one group member to another. For example, suppose that a parent makes a loan to a foreign subsidiary. If the loan is denominated in the subsidiary's functional currency, the parent will report a gain or loss on translation when there is a change in the exchange rate. In the consolidated financial statements, the loan will not be reported (the parent's asset will be offset against the subsidiary's liability). However, what is to be done about the translation gain or loss that was reported by the parent in its individual statements? IAS 21 covers this matter in paragraph 45 as follows:

> an intragroup monetary asset (or liability) . . . cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference is recognised in profit or loss . . .

In the author's opinion, the reasoning set out in the above quotation is faulty. The IASB claims that a group should report a gain or loss in respect of an intra-group transaction. This is contrary to the fundamental principle that intra-group profits and losses should be eliminated in the consolidated financial statements. In the case of an intra-group sale, the profit on the sale (which is correctly reported in the individual statements) is eliminated in the consolidated financial statements. The same principle applies to the gain or loss on the intra-group loan that is reported in the parent's individual statements.

The fault in the IASB's reasoning will be explained with the aid of an example, the details of which are set out in Table 17.9. A German parent owns an American subsidiary. The subsidiary owns assets of \$100,000 financed by equity of \$20,000 and a loan of \$80,000, both provided by the parent. Assume that the group owns no other assets and that there were no transactions in 2014. During 2014 the exchange rate fell from \$1 = €0.80 at the start of the year to \$1 = €0.73, a loss of €0.07 per dollar. The German parent therefore reported a loss of €5,600 (\$80,000 = €0.07/\$1) on its loan in its individual financial statements. The American subsidiary's balance sheets at the start and at the end of 2014, both in the subsidiary's functional currency (\$) and the presentation currency (a), are presented in Table 17.9. The translated value of the subsidiary's equity fell from €16,000 at the start of the year to €14,600 at the end, a translation loss of €1,400. The total loss suffered by the group during 2014 may be calculated by comparing the value of the group's assets at the start (€80,000) with their value at the end (€73,000), an overall loss of €7,000. According to the IASB's reasoning this loss is made up of:

Translation loss on the subsidiary's equity	€1,400
Translation loss on the loan	€5,600
Total loss	€7,000

Table 17.9 An example of intra-group loans

	Balance sheets of the US subsidiary		
At 1.1.2014	**$**	**Translation factor**	**€**
Assets	100,000	€0.80/$1	80,000
Loan	80,000	€0.80/$1	64,000
Equity	20,000	€0.80/$1	16,000
At 31.12.2014	$		€
Assets	100,000	€0.73/$1	73,000
Loan	80,000	€0.73/$1	58,400
Equity	20,000	€0.73/$1	14,600

Hence, it is claimed that it is necessary to include the translation loss on the loan in the consolidated income statement, in order to report correctly the full amount of the loss.

However, in the author's opinion, the translation loss on the subsidiary's equity should be decomposed into its constituent elements, leading to the following calculation:

Translation loss on the subsidiary's assets	$100,000 × €0.07/$1	€7,000
Less translation gain on loan	$80,000 × €0.07/$1	€5,600
Equals translation loss on subsidiary's equity		€1,400
Translation loss on loan		€5,600
Total translation loss		€7,000

The two amounts of €5,600 should be set off against each other, which makes clear that the total translation loss of €7,000 relates solely to the subsidiary's assets.

In the author's opinion, the IASB's presentation of the total loss is wrong, because it gives the impression that the group suffers a loss arising from a transaction between its members. Furthermore since, according to IAS 21, the translation loss on the loan is a charge in the consolidated income statement, whereas the other translation losses are transferred direct to reserve, the effect of the IASB's presentation is to reduce the reported profit. The IASB justifies its treatment on the grounds that 'the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations'. In the author's opinion, this is wrong. Any loss suffered by one group member arising from the monetary item will be exactly offset by the gain accruing to another member. The reporting entity (the group) makes no profit or loss from a contract made between its members.

Accounting students will no doubt find it rather alarming that such a distinguished body as the IASB can make such a patently incorrect statement. However, one should always treat the pronouncements of 'experts' with caution. Status does not confer infallibility.

17.10 Research findings

17.10.1 Walker

Economists and some accountants criticize the translation methods described in the previous sections as leading to the calculation of asset values and exchange gains and losses that are not in accordance with economic reality. Walker (1978) argues that the foreign subsidiary's value should be taken as the net present value of future cash flows. He states that 'economic analysis recognizes that a devaluation of the foreign subsidiary's local currency will not automatically reduce the parent currency value of the foreign subsidiary's net assets as is suggested by the accounting approach'. But although he analyzes in detail the effect of devaluation on a foreign subsidiary's cash flow, he is unable to arrive at any general rule. There are practical difficulties of estimation, but 'despite these difficulties, the economic analysis of exchange risk is clearly the right approach'.

In fact, one suspects that most accountants would not take exception to Walker's two main conclusions: that balance sheet values of assets determined in accordance with generally accepted accounting principles are poor indicators of economic values; and that it is very difficult to estimate future cash flows. Most accountants would probably add that it is not intended that the conventional balance sheet should reflect economic values.

17.10.2 Aliber and Stickney

A startling view was proposed by Aliber and Stickney (1975). By the use of two economic theories, they prove that changes in exchange rates have no effect on the values of foreign subsidiaries. The two theories are:

1 the purchasing power parity (PPP) theorem, which states that changes in the exchange rate between two countries are proportional to changes in the relative price levels;
2 the 'Fisher effect', which states that, between two countries, the differential in the interest rates earned on similar financial assets is equal to the expected change in the exchange rate.

The implications of the PPP theorem can be examined using a simple example. At the start of a year, a British company constructs two identical factories: one in Britain costing £100,000 and one in Ruritania costing R$100,000, the exchange rate at that time being £1 = R$1. It has undertaken the investment in the expectation of a 20 per cent annual return, anticipating an annual cash flow in real terms in perpetuity of £20,000 in Britain and $20,000 in Ruritania, after charging the annual cost of replacing worn-out plant. During the next 12 months, prices in Ruritania rise by 50 per cent. The anticipated annual cash flow from the Ruritanian factory is now $30,000. Prices in Britain rise by 10 per cent; the anticipated annual cash flow there is now £22,000. The new exchange rate, as predicted by the PPP theorem, is £1.10 = $1.50. The future cash flows of the two factories at this new exchange rate are identical; hence, the factories' values are identical. The change in the exchange rate has not affected the value of the Ruritanian factory.

The implications for translation are most interesting. If historical cost is used as the basis of valuation of assets, the British factory will be shown in the balance sheet at £100,000. For the Ruritanian factory to be shown in the consolidated balance sheet at the same value, the historical cost in terms of local currency ($100,000) must be translated at the historical exchange rate. If assets are stated at the net present value of future cash flows, the situation is a little more complex: the British factory has a value of £110,000 (i.e. £22,000 × 100 ÷ 20) and the Ruritanian factory a value of $150,000 (i.e. $30,000 × 100 ÷ 20). To achieve identical values, the Ruritanian factory's present value must be translated at the current exchange rate. If the PPP theorem is correct, this analysis proves to be a convincing justification of the temporal method (historical cost translated at historical rates; present values translated at current rates).

The 'Fisher effect' will be illustrated using the same example. The two factories, one in Britain and the other in Ruritania, are each financed by a local loan. Lenders demand a 5 per cent real return after taking into account the expected rates of inflation as before. Hence the nominal rate of interest will be 15.5 per cent in Britain and 57.5 per cent in Ruritania. After 12 months, the exchange rate will have moved from £1 = $1 to £1.10 = $1.50. This is all as predicted by the 'Fisher effect': the interest rate differential (1.575 ÷ 1.155 = 1.36) is identical to the change in the exchange rate (1.50 ÷ 1.10 = 1.36). In other words, a person with £100,000 who invested it in Britain at the start of the year would be exactly as well off as if they had invested it in Ruritania. In the first case they would have £115,500 at the end of the year; in the second case they would have $157,500 which, at the current exchange rate of £1 = $1.36, is worth £115,500. If this were not the case – if, for example, the return in Britain were higher – arbitrage between the two markets should cause the gap to close; investors would invest less in Ruritania, lend more in Britain, bringing about lower interest rates in Britain and higher interest rates in Ruritania as the markets adjusted to the relative shortage and glut of funds.

The implications for accounting are interesting. As the real rate of interest is the same for both loans, one would expect their financing cost, as reported in the consolidated income statement, also to be the same. As the interest costs of the Ruritanian loan are so much higher than those of the British loan, this can only be achieved by deducting from the interest cost of the Ruritanian loan the fall in its sterling value, i.e. by translating the loan at the closing rate. If this is done, the financing cost of the Ruritanian loan, in terms of sterling, can be calculated as follows:

Interest: 57.5% of $100,000 = $57,500 × £1 ÷ $1.36 = £42,167	
Less fall in value of loan:	
Start of year:	
$100,000 × £1 ÷ $1 = £100,000	
End of year:	
$100,000 × £1 ÷ $1.36 = £73,333	(£26,667)
Total financing costs	£15,500

The net cost of the Ruritanian loan (£15,500) is, of course, equal to the interest cost of the British loan.

The temporal principle is again vindicated. In this case it is the rather old-fashioned CNC method that is shown to be incorrect. Also the example shows that the practice of excluding translation gains and losses from income is wrong, since the

true cost of financing a foreign loan can be established only after taking into account both the interest payments and the exchange loss or gain relating to the capital value of the loan.

It should be noted that Aliber and Stickney (1975) were in error in stating that their analysis of the 'Fisher effect' showed the temporal principle of translation to be wrong. They were correct in stating that it showed that financial liabilities were not subject to exchange risk, since the total financing cost will be the same no matter where the liability is located; however, they inferred from this that the capital value of a foreign loan should not be adjusted for changes in the exchange rate, and this is incorrect. Only by taking into account the loss (or gain) on the loan can the true cost of financing be shown.

The misleading impression given by charging translation losses on loans to the reserves is well illustrated by the case of the British company Polly Peck, which collapsed spectacularly in 1990 (Gwilliam and Russell, 1991). Polly Peck had invested heavily in bank deposits in Turkey that earned a rate of interest of 30 per cent per year, whereas its borrowings were principally in dollars and sterling on which it paid around 10 per cent per year. The interest rate differential can be explained entirely by the 'Fisher effect'. The Turkish lira was expected to fall against the dollar and sterling by around 20 per cent per year, as it had done in the past. The interest received and paid was reported in the income statement; the loss on translation on the bank deposits in Turkey was charged against the reserves. The net result was that in 1989 Polly Peck reported in its income statement a surplus of £12 million of interest received over interest paid, despite the fact that, at the end of 1989, its monetary liabilities exceeded its monetary assets by over £700 million. In charging the translation loss on its foreign deposits to reserves, Polly Peck was following the letter of the relevant standard (SSAP 20) but it was undoubtedly presenting a very misleading picture of its financing costs.

17.10.3 Beaver and Wolfson

Probably the most rigorous analysis of the translation problem has been made by Beaver and Wolfson (1982). They analyzed the effect of three translation methods with respect to two properties of the translated consolidated financial statements:

- economic interpretability, which occurs when:
  - the book values reported in the balance sheet are equal to the present values of the future cash flows of the assets, liabilities and net worth of the firm;
  - the reported return on investment (net income divided by beginning-of-year assets) is equal to the nominal rate of return on investments, denominated in terms of the domestic currency.
- symmetry, which occurs when:
  - two economically equivalent investments (one foreign, one domestic) produce the same financial statement numbers when translated into a common currency.

The translation methods that were analyzed were:

- *H/H:* historical cost financial statements translated at historical rates of exchange, i.e. one application of the temporal method.

- *H/C:* historical cost statements translated at the current rates of exchange, i.e. one application of the current rate method.
- *C/C:* 'comprehensive market value accounting' translated at current rates of exchange, i.e. a second application of the temporal method and of the current rate method.

These three methods were analyzed using a rigorously defined mathematical model. The conclusions come as no surprise:

1 The H/H method possesses symmetry but not economic interpretability. The symmetry occurs because, under the temporal method, the accounting principles that underlie the foreign currency financial statements are retained in translation. The economic interpretability is lacking because it does not exist in the foreign currency statements; under historical cost accounting, the book values of assets are normally not equal to their present values. One cannot, through translation, import a characteristic into the translated statements that is lacking in the foreign currency statements.
2 The H/C method possesses neither symmetry nor economic interpretability.
3 The C/C method possesses both symmetry and economic intepretability.

These conclusions represent a resounding confirmation of the temporal method and a thorough condemnation of the current rate method. They also form the rigorous proof of the author's statement in Section 17.5 above that the translated value of the historical cost of an asset under the current rate method is meaningless.

17.10.4 Louis

Louis (2003) empirically examines the change in a company's value compared to the size and direction of its disclosed foreign currency translation numbers. He looks particularly at US manufacturing companies, and finds that the accounting rules generally produce results opposite to the economic effects of exchange rate changes. Again, evidence piles up against the propriety of existing accounting practices.

17.11 An alternative to exchange rates?

So far in this chapter it has been assumed that the conversion factor to be used in translation should be an exchange rate: either a historical rate or a current rate. However, there is a school of thought that rejects the use of exchange rates; instead it proposed the use of a purchasing power parity index (PPPI), which is defined as:

$$\frac{\text{The purchasing power of the domestic currency}}{\text{The purchasing power of the foreign currency}}$$

Purchasing power is measured in much the same way as the price level. A representative basket of goods and services is priced, first in the domestic currency (in the home country) and secondly in the foreign currency (in the foreign country). The ratio of the two numbers is the PPPI.

The principal advocate of this approach was Patz (1977), who argued that the purpose of translated statements is:

> to express the economic power and results of the operations of the foreign firm, viewed as a viable concern expected to continue to operate for the foreseeable future in its present setting, in terms of that setting. The objective of the firm is the maximization of command over goods and services locally, not maximization of command over domestic currency. Consequently the focus of reporting should be on this local command over goods and services.

Given these assumptions, the use of a PPPI is logical. In theory the substitution of a PPPI for an exchange rate would be simple. The whole of this chapter could be rewritten, substituting 'PPPI' for 'exchange rate' wherever it occurs; for example a distinction could be made between historical and current PPPIs.

For the moment, the use of PPPIs in translation remains a completely theoretical issue. They are not permitted by any accounting standard, and, to the author's knowledge, no company uses them for its income statements. Certainly, if ever the use of PPPIs were to become acceptable then attention would need to be given to the practical problem of constructing objective and accurate indices. It is by no means obvious how one would compare the cost of chicken tandoori in London with that of sauerkraut in Berlin or of chilli in Rio de Janeiro!

SUMMARY

- Translation is the process whereby financial data expressed in terms of one currency are restated in terms of another currency. It becomes necessary in two situations:
  - *Translation of transactions*, when transactions denominated in foreign currency are accounted for in the accounting records and financial statements of an individual company.
  - *Translation of financial statements*, when a parent company owns a foreign subsidiary and needs to incorporate its foreign currency statements in consolidated statements.
- For translation of transactions, there is general agreement that the historical rate should be used for the translation of non-monetary assets. For monetary assets and for liabilities, the closing rate is generally used, except under the national rules in some countries that prefer the prudence principle to the accruals principle.
- Under US GAAP and IFRS, gains and losses on the translation or settlement of monetary balances are treated as profit or loss.
- The traditional methods of translation of financial statements are: (a) the current rate method, which uses only current rates; (b) CNC, which uses historical rates for non-current balances; and (c) the MNM, which uses historical rates for non-monetary balances. Naturally, as exchange rates change, different methods lead to different results, including the size of gains and losses on translation.
- A new approach was made in the early 1970s by the AICPA, leading to SFAS 8, which introduced the temporal principle under which a balance is translated at

the exchange rate ruling when its valuation basis was established. Under historical cost accounting, this leads to results similar to the MNM method. However, the temporal principle applies equally well for current value or any other system of accounting.

- Under the temporal method, translation gains and losses are recorded as profit or loss. Under the current rate method, they are shown as other comprehensive income.
- There was considerable opposition to the enforced application of the temporal method in the United States, particularly from companies that preferred to use the current rate method. In 1981 the FASB issued SFAS 52, which made the current rate method the normal standard; the temporal method was only to be applied in certain well-defined, exceptional circumstances. The same line was followed by the IASC (in IAS 21).
- US GAAP and IAS 21 refer to an entity's 'functional currency'. If a subsidiary has a different functional currency from the currency of the group's financial statements, the current rate method is used for translation. If the subsidiary has the same functional currency as used in the group's financial statements, the temporal method is used if the subsidiary's statements are in another currency.
- Academic research relating to translation concludes that, from a theoretical viewpoint, the temporal method is to be preferred to the current rate method.

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Further reading

For an introduction to translation, see IAS 21 (IASB, 2003).
For an analysis of the temporal and other methods, see Lorensen (1972).
For a defence of the current rate method, see Parkinson (1972).
For an analysis of the USA's and the IASB's regulatory systems, see Flower and Ebbers (2002).
For the economic aspects of translation, see Walker (1978) and Aliber and Stickney (1975).
For a review of the translation debate, see Nobes (1980).
For the case in favour of purchasing power parity, see Patz (1977).
For the translation of transactions, see Radebaugh *et al.* (2006, Chapter 10).
For an analysis of the rules and practice in continental Europe, see Ebbers (1997).

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

17.1* Why was there so much controversy over currency translation methods for group accounting? Which method do you prefer?

17.2* Why has it been difficult, particularly in the United States, to create a satisfactory accounting standard on foreign currency translation?

17.3 Are gains on unsettled foreign currency balances realized? When should they be recognized as income?

17.4 Is there a single best method of currency translation?

17.5 Does accounting translation exposure matter? Explain your reasoning.

17.6 Discuss how different attitudes to prudence can affect foreign currency translation policies.

18 Segment reporting

Clare B. Roberts[1]

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OBJECTIVES

After reading this chapter, you should be able to:

- explain the nature and purposes of segment reporting;
- outline the development of segment reporting;
- describe the current segment disclosure requirements of the IASB;
- outline the major practical problems encountered when trying to identify segments or trying to write rules on this subject; and
- explain the contributions of research to the understanding of the benefits and costs of segment reporting.

18.1 What is segment reporting?

It has long been recognized that users of financial statements need consolidated information about a group (see Chapter 16). However, the consolidated financial statements do not provide all the information needed, and the annual report of any large company typically includes much more information. For example, it includes non-financial narrative disclosures describing the activities of each of its divisions or each major part of

[1]This chapter is a revision (by Christopher Nobes) of the chapter in the 11th edition.

the company. Also included, usually in the notes to the financial statements, are disaggregated or segmented financial information, commonly referred to as segment reporting. This involves breaking down the entity into its constituent parts or segments and reporting data for each of these. A company can segment its operations in a number of different ways. It could use its operating structure as a basis of segmentation, reporting results for each of its major divisions (usually called the management approach). Or, irrespective of this structure, it could disaggregate on the basis of industry or type of business (often called line of business, or LoB), or on the basis of geographical area (in terms of either locations of operations or locations of customers).

It is not only the method of segmentation that varies, but also the number of segments disclosed, and the number and type of items of information provided. At one extreme, segment information might relate only to key figures such as sales or earnings, while at the other extreme most of the consolidated data could be disclosed in a segmented or disaggregated form. Similarly, differences may occur with respect to the accounting policies used, which are sometimes not identical to those used in the published group statements, meaning that the segmented figures disclosed might not explicitly articulate with the group statements.

An example of a very simple set of geographical segment disclosures is given in Table 18.1, which reproduces the types of disclosures that were typically found in annual reports in the early 1990s. In contrast, Table 18.2 shows the disclosures made by the same company in 2014. By then, instead of only providing operating profit and turnover (i.e. sales) the company was providing extensive income statement and balance sheet information, with information on consolidation adjustments. In addition, it was providing certain information by geographical segments.

Table 18.1 BP's income statement segment information, 1990 (£m)

	Replacement cost operating profit		Turnover	
By business	**1990**	**1989**	**1990**	**1989**
Exploration and production	**2,086**	1,574	7,837	6,855
Refining and marketing	**853**	732	24,025	20,598
Chemicals	**129**	548	3,164	3,164
Nutrition	**48**	35	2,682	2,620
Other businesses and corporate	**(154)**	48	390	884
	2,962	2,937	38,098	34,121
Less: sales between businesses			5,059	4,480
Total	**2,962**	**2,937**	33,039	**29,641**
By geographical area				
UK	**406**	787	**12,209**	9,428
Rest of Europe	**571**	525	**10,093**	9,265
USA	**1,470**	1,334	**10,402**	9,938
Rest of World	**515**	291	**3,664**	3,398
	2,962	2,937	**36,368**	32,029
Less: sales between areas			**3,329**	2,388
Total	**2,962**	**2,937**	**33,039**	**29,641**

Table 18.2 BP's segment analysis, 2014 ($m)

By business	Upstream	Downstream	Rozneft	Other	Consolidation adjustment/ eliminations	Total group
Segment revenues						
Sales and other operating revenues	65,424	323,486	–	1,989	(37,331)	353,568
Less: that between segments	(36,643)	173	–	(861)	37,331	–
Third party amounts	28,781	323,659	–	1,128	–	353,568
Equity-accounted earnings	1,089	265	2,101	(83)	–	3,372
Segment results						
Profit (loss) before interest and taxation	8,848	(2,362)	2,076	(2,791)	641	6,412
Finance costs						(1,148)
Finance costs of post-retirement benefits						(314)
Profit before taxation						4,950
Other income statement items						
Depreciation:						
US	4,129	984	–	97	–	5,210
Non-US	8,404	1,336	–	213	–	9,953
Fair value loss on derivatives	(430)	–	–	–	–	(430)
Provisions	260	713	–	1,652	–	2,625
Segment assets						
Equity-accounted investments	7,877	3,244	7,312	723	–	19,156
Additions to non-current assets	22,587	3,121	–	784	–	26,492
Other investments						160
Other acquisitions						(366)
Decommissioning						(2,505)
Total capital/acquisitions	19,772	3,106	–	903	–	23,781

Source: Prepared by the authors from information in BP's annual report, 2014.

Many users of financial reports are interested in the performance and prospects of one particular part of the company rather than the company as a whole. For example, the security of employment, pay and conditions of employees is generally more dependent upon the performance of the specific factory or division in which they

work than upon that of the group as a whole. Similarly, a host government will be primarily interested in the performance of the part of the group which is located in its country. Customers, suppliers and creditors are instead most interested in the subsidiary with which they have contracted. All of these users will therefore want disaggregated information.

However, segment information is not usually sufficiently disaggregated to be of very much help in meeting these needs. In some cases, the annual report of an individual legal entity will serve the users' needs. In some cases, the group report may be interesting and segment reporting can help to provide extra insights into the group and its performance. For example, employees may want information about the entire group because companies may sell off a profitable but peripheral subsidiary to generate cash to protect less profitable domestic or core operations. Shareholders, in contrast, invest in the group as a whole and it is therefore the performance and prospects of the entire group that they are interested in, rather than those of any individual segments. Therefore, at first sight, segment reports are of even less relevance to shareholders. But this is to misunderstand the purpose of segment reports. A group is made up of its constituent parts, and to understand fully its performance and prospects (and make predictions about them) it is necessary to consider the performance and prospects of each part. This will be the case in particular if the company is diversified, operating across a range of different industries or geographical areas.

Different segments may have very different profit potentials, growth opportunities, capital needs and degrees and types of risk. The past performance of a company and its future prospects will therefore usually be better understood if the user also has segment information. Thus, for example, the international standard IFRS 8 sets out the core principle of segment reporting as follows:

> An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. (paragraph 1)

18.2 Segment reporting regulations

18.2.1 Some historical context

Segment reporting has been highly controversial, both technically and politically. This sub-section provides a background to that. Then, 18.2.2 outlines the content of the current international standard, IFRS 8. That leads to a discussion of (in 18.2.4) the response by preparers, users and politicians to the proposals in IFRS 8. Later, Section 18.3 looks at research findings about segment reporting, including an assessment of the impact of the current US and IFRS requirements on corporate reporting practices.

As discussed in Chapter 5, the IASB and the USA commenced in 2006 a short-term convergence project designed to eliminate all the minor differences between their standards. As a part of this, the IASB agreed to review its then segment standard, IAS 14. The IASB did not expect the resulting revised standard (IFRS 8) to be contentious as it was simply designed to achieve 'convergence with the requirements of SFAS 131, except for minor differences' (IFRS 8, paragraph IN3); and the US standard appeared

to have been operating satisfactorily since it was issued in 1997. However, IFRS 8 created great controversy, as explained below in 18.2.2. This can only be understood if the differences between IFRS 8 and the preceding standards are clear. So, some historical context is useful.

Disclosure requirements about segments were introduced in the USA in 1969 when the Securities and Exchange Commission (SEC) required the disclosure of LoB information in registration documents. From 1970, companies had to make similar disclosures in the annual Form 10-K, and from 1974 in their annual reports. SFAS 14 *Financial Reporting for a Segment of a Business* (FASB, 1976) was the first significant accounting standard in this area.

The IASC first issued a standard on segment reporting (IAS 14, *Reporting Financial Information by Segments*) in 1981. This followed SFAS 14 fairly closely by requiring, for both LoB and geographical segments, information on the following: sales, with internal and external revenues shown separately; operating results; identifiable assets (in either absolute or relative terms); and, if necessary, a reconciliation statement, explaining any differences between the sum of the segment sales, profits or assets disclosed and the total or consolidated figures. In addition, companies were required to describe the activities of each line of business, the composition of each geographical segment and the basis used to determine the value of intra-group transfers.

SFAS 14 eventually received much criticism from a number of sources. The requirement to report geographical and LoB segments had been designed to ensure the disaggregation of operations in distinctly different environments. Activities with similar risks or returns were placed in the same segment but activities likely to yield significantly different risks or returns were placed in different segments. This helped to ensure comparability across companies and it meant that the segment data could be combined with external data, whether industry-based or country-based, to allow the user to understand the company's environment and so better assess its prospects.

However, SFAS 14 ignored the internal structure of a company. The segments might have to be created only for external reporting purposes and could be quite different from how the company operated or how corporate information was disaggregated for internal decision-making. Furthermore, this information could be expensive to produce as it might require the redesign of information systems. This might have been worthwhile if the information were useful for investors, but it is not clear that information on artificially created LoB and geographical segments is the most useful. Users who only have such information might fail to understand the sorts of major operating or investment decisions the company makes or to understand its policies or plans.

These problems are compounded because the interests of users are often different from those of the company. Managers may be concerned not only with the direct costs of disclosure, but also that disclosing segment data may highlight particularly poor or good performance. The possibility that managers might deliberately choose segments to hide particularly sensitive information was increased because SFAS 14 contained little guidance in a number of areas, including segment identification and how to measure the items reported.

The FASB faced pressure to withdraw SFAS 14. Particularly important were the views of financial analysts, as represented by the Association for Investment Management and Research (AIMR, now the CFA Institute). An AIMR position paper of 1993 concluded that SFAS 14 had resulted in many companies' defining segments

too broadly and not giving enough information, either in annual reports or crucially in quarterly reports. In the following year, the American Institute of Certified Public Accountants' Special Committee on Financial Reporting (the Jenkins Committee) issued its recommendations, the first of which was for more segment reporting. It called for significant improvements with respect to:

(a) information in interim financial reports,
(b) an increase in the number of segments generally reported,
(c) more items of segment information,
(d) segments consistent with internal management reports, and
(e) segments consistent with other information in the financial reports.

At the same time, the Canadian and US standard-setting bodies set up a joint project to review their segment standards. This resulted in new standards: CICA Handbook Section 1700, and SFAS 131 (FASB, 1997), respectively.

The IASC collaborated with FASB in this process and it also issued a revised version of IAS 14 in 1997. While this did not go as far as SFAS 131, it involved some substantial changes to the method of identification of segments and to the disclosure requirements. Specifically, instead of requiring the same amount of information for both LoB and geographical types of segments, it required a company to choose one basis as the primary basis and the other as the secondary. Although this choice was supposed to be based on the internal operating and reporting structure of the entity, IAS 14 (unlike SFAS 131) required all companies to report on these two bases, even when the internal structure was different from either.

The revised IAS 14 defined a business segment as:

> a distinguishable component of an entity that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

IAS 14 similarly stated that a geographical segment was:

> a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

Also, more items of information were required about the primary segments. In contrast, the disclosure requirements for the secondary basis were very much less onerous, namely only:

- external revenues;
- carrying amounts of assets; and
- capital expenditures.

IAS 14 defined segment earnings and assets (these should include all items that were directly attributable or could be reasonably allocated) and, unlike SFAS 131, it required that the accounting policies used should be the same across all segments and the same as those used for external consolidated reporting.

Although IAS 14 provided guidance on segment identification, it is clear that discretion was still left to companies. This meant that companies that wished to provide either minimal disclosures or 'good news' had some discretion to manipulate their

segment disclosures to achieve these objectives. The scope for this was reduced by also requiring the disclosure of changes in the segments reported. Thus, if a company changed the policies adopted, it had to disclose the nature of the changes, the reasons for them and their effect. If it instead changed the segments disclosed, the comparative tables had to be restated to reflect the changes. As explained later, this is an area where IFRS 8 appears to have been designed to make reporting easier.

As might be expected, the revision of IAS 14 appears to have led to an increase in the number of items disclosed. There is also evidence that it led to an increase in consistency between segment disclosures and other information in the annual report, although a significant number of companies still reported segments that appeared to conflict with other information provided and compliance was generally low. For example, in a study of annual reports of 1997–1999, Prather-Kinsey and Meek (2004) found that up to one-third of their sample did not disclose most of the required items. In addition, geographic segments too often remained vague and poorly defined (Street and Nichols, 2002). It is not clear whether this reflected a general lack of compliance with international standards at that time or a particularly low level for segment reporting.

18.2.2 The main requirements of US GAAP and IFRS 8

Current US GAAP (ASC 280-10) derives from SFAS 131 of 1997, mentioned above. This had introduced the 'management approach' to the identification of segments. As part of an IASB/FASB convergence project, the IASB issued ED 8, *Operating Segments*, in January 2006, followed by IFRS 8 in November 2006. The standard applied for financial years starting on or after 1 January 2009 and optionally before that. This sub-section examines the main requirements of US GAAP and IFRS, using the IFRS 8 references. At the end, there is a note on the minor differences between US GAAP and IFRS.

Obviously, the IASB had reviewed the arguments for and against the US standard, SFAS 131, before deciding to converge with it. This included whether to adopt the management approach both for the identification of reportable segments and for the selection of the information to be reported. Under the management approach, the main basis of segmentation is determined not by reference to external features of the environment, but instead to the internal operating and reporting structure of the enterprise. The idea is that whatever is the most suitable basis for segmenting the information used by the top managers should also be suitable for the outsiders who try to assess the business. The standard thus refers to an 'operating segment', defined (paragraph 5) as a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
(b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
(c) for which discrete financial information is available.

The chief operating decision maker (CODM) is the individual or group of individuals who regularly assess the performance of, and allocate resources to, the operating

segments of the entity. This may be the chief executive officer, but it may instead be a committee of executives.

The internal structure, and therefore the reporting, of an enterprise may be based upon industry or geography. However, it may instead use a combination of these or indeed any other basis. IFRS 8 therefore marked a significant change from IAS 14 which required entities to report on either the line of business or the geographical basis irrespective of its internal structures. In addition, unlike under IAS 14, the logic of the management approach means that the reported segments do not necessarily have to generate significant external revenues. Instead, segments should be disclosed if they are reported to the CODM, even if they generate only internal sales or no sales at all because they are start-up segments.

Once the operating segments are identified, the company must decide if they are reportable. That is, for financial reporting, segments may be aggregated into larger units if this does not result in the loss of useful information, i.e. as long as the aggregation:

> is consistent with the core principle of this IFRS, the segments have similar economic characteristics and the segments are similar in each of the following respects:
>
> **(a)** the nature of the products and services;
> **(b)** the nature of the production processes;
> **(c)** the type or class of customer for their products and services;
> **(d)** the methods used to distribute their products or provide their services; and
> **(e)** if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities. (paragraph 12)

Individual segments may also be combined into an 'all other segments' category if they are small (i.e. less than 10 per cent of the combined total) in terms of revenues (external plus internal), or profit or loss,[2] or assets, provided that individual operating segments make up at least 75 per cent of total revenues.

We can now turn to the items to be disclosed. All companies must disclose the segmented profit or loss. Apart from that, the idea that segment reporting should be based on the type of information seen by the CODM affects which items should be disclosed. Thus, segment total assets and total liabilities should be disclosed if regularly reported to the CODM. Further, the following must be disclosed if they are either: (i) included in the calculation of segment profit or loss; or (ii) regularly provided to the CODM:

- external and internal revenues;
- interest revenue and expense;
- depreciation and amortization;
- material items of income and expense;
- interest in profit or loss of associates and joint ventures;
- income taxes;

[2]Segment profit should be compared to the total profit of all segments making a profit and segment losses should be compared to the combined loss of all segments that make a loss.

- material non-cash items other than depreciation and amortization;
- investment in associates and joint ventures;
- additions to non-current assets, excluding financial instruments and similar.

While most of these items had been required by IAS 14, four new items are: interest revenue and expense; other material items of income and expense; income taxes; and investment in associates and joint ventures. Table 18.3 provides an illustration of such disclosures, as required by SFAS 14 and IFRS 8.

Although the disclosures under IFRS 8 mean that users can see the information that forms the basis of internal decision-making, this may involve a loss of consistency and comparability both across the segments of the company and across different companies. Different companies and even different segments of the same company may use different (possibly non-IFRS) accounting policies and different definitions of profits or assets. To some extent the problem of lack of comparability within any one company is mitigated by the additional requirement that companies must disclose, where relevant, a reconciliation explaining the differences between aggregate segment and consolidated figures.

To help further with understanding the group and with comparability between groups, entities must also disclose some entity-wide information about industry and geographical segments and major customers if any of this is not reported already. This entails the disclosure of the revenue from:

- each product and service or group of products and services;
- external customers located in the enterprise's country of domicile;
- external customers in all foreign countries in total;
- external customers from individual countries if material;
- any single customer accounting for 10 per cent or more of revenues.

Table 18.3 Segment disclosures by Lakeside (US) for 2015* ($000)

	US wholesale	US retail	International	Unallocated corporate	Consolidated
Revenue	$795,240	$290,434	$605,224	$ –	$1,690,898
Depreciation and amortization	764	2,680	4,506	14,553	22,503
Operating income/(loss)	277,957	27,213	63,257	(129,602)	238,825
Interest expense	–	–	–	884	884
Other, net	–	–	–	(828)	(828)
Income/(loss) before income taxes	277,957	27,213	63,257	(129,658)	238,769
Total assets	157,089	28,064	152,691	300,827	638,671
Goodwill	6,804	794	6,565	–	14,163
Expenditures for capital additions	3,190	2,339	5,555	9,848	20,932

Note: *This relates to a fictitious company. Comparatives for previous years omitted.

Also required is disclosure of non-current assets except financial instruments and a few other items, located: in the country of domicile; in all foreign countries; and in all material individual countries. In all cases, this information is only required if it is already available or can be generated at a cost which is not excessive.

IFRS 8 differs from US GAAP with respect to three relatively minor issues. First, although both standards require the disclosure of certain non-current assets if these are reported to the CODM, US GAAP restricts this to tangible assets, whereas IFRS 8 covers intangible assets as well. Secondly, US GAAP does not require the disclosure of segment liabilities. Finally, if the entity operates using a matrix form of organization, then it should report on whichever basis best meets the core principle of IFRS 8 and not, as with US GAAP, automatically on a product/service basis.

18.2.3 Users' and preparers' views on the proposals for IFRS 8

The IASB's exposure draft that preceded IFRS 8, ED 8 *Segmental Reporting*, generated 182 comment letters, or 102 if we exclude those concerned only with the requirement to disclose information about single countries. The respondents were far from unanimous in their views, with some strongly in favour and others equally strongly against. Katselas *et al*. (2011) show that larger companies (and those with three or more segments) lobbied in favour of ED 8 more than small ones did. A number of respondents argued that, while there might have been a need to replace IAS 14, there was no need to consider this issue as a part of the comparability project with the FASB. This view was taken by the two IASB board members who offered a dissenting opinion. The standard is about disclosures, it does not affect the information reported in any of the main financial statements and so it does not affect the issue of whether or not foreign companies listing in the USA needed to produce a reconciliation statement, which was one of the concerns of the time.

Of the 102 letters referred to above, the approach as adopted by SFAS 131 (management segments and information as presented to the CODM) received the most support, with 51 per cent of respondents, mainly preparers, supporting it. In contrast, IAS 14's approach was supported by only 18 per cent, who were mostly users. As might be expected, these respondents argued that using risk and return criteria to identify segments and using consistent accounting rules means that the information disclosed is more comparable and less subject to manipulation. Also, being based on consolidated IFRS reporting, it should be easier to understand and less misleading for users. Other respondents (19 per cent) preferred the management approach for segment identification, but consistent rules for disclosure. The two dissenting IASB board members strongly supported this view, arguing that 'proper external reporting of segment information should not permit the use of non-GAAP measures because they might mislead users' (IFRS 8, paragraph D04).

In response to these views, the IASB concluded that the management approach was the better alternative, providing more useful information, as it would mean that:

- **(a)** entities will report segments that correspond to internal management reports;
- **(b)** entities will report segment information that will be more consistent with other parts of their annual reports;
- **(c)** some entities will report more segments; and
- **(d)** entities will report more segment information in interim financial reports.

(IFRS 8, paragraph BC 9)

The IASB also felt that the new segment identification rules had the advantage for reporting entities that:

> the proposed IFRS would reduce the cost of providing disaggregated information for many entities because it uses segment information that is generated for management's use. (IFRS 8, paragraph BC 9)

Although the IASB supported in principle the requirement to use consistent IFRS GAAP-based rules, they thought that this would present particular problems for interim reporting as the information needs to be prepared and reported under very tight deadlines. So, IFRS 8 allows companies to report segment information using non-GAAP rules. The IASB argued that the requirement to provide reconciliation information when different rules are used ensures that users are not misled. A number of other issues were also raised by the respondents. For example, concern was expressed over the use of quantitative thresholds, being more a rules-based than a principles-based approach to standard setting, and allowing exemptions due to cost rather than impracticality. Suggested changes to the required disclosures included: disclosure of segment assets only if reported to the CODM (this change was made in 2009); the need for reconciliations at the individual segment level; and disclosures by geographical areas and for the most important country, rather than country of domicile and other material countries.

The Quoted Companies Alliance (QCA), a UK association of the smaller (non-FTSE 350) UK quoted companies, and 10 of its supporters, were concerned that disclosure of segment information could be commercially sensitive for smaller companies. The argument was found in an identical or similar form in all the letters:

> We are very concerned that these proposals do not provide an exclusion for commercially sensitive information. As a smaller quoted company it is sometimes very important that the results of new business streams are not directly evident to our competitors, until they are well established.
>
> We wish to suggest that an opt-out based on a 'comply or explain' basis is made available to smaller quoted companies to avoid damage to growing businesses.

However, the IASB argued that any general exemption on the basis of competitive harm would provide too much scope for non-compliance and that there was little evidence that competitive harm would result, given that most competitors would already have access to other, more detailed sources of information.

Eighty comment letters came from supporters of the Publish What You Pay (PWYP) campaign. This had been started in 2002 by George Soros with the aim of helping citizens in resource-rich developing countries to hold their governments accountable for the management of revenues from oil, gas and mining industries. It called for the disclosure of payments made by the companies in those industries to governments on a country-by-country basis. These 80 supporter organizations sent the same, or very similar, letters, the main points of which are shown in the following quotation:

> As a supporter of Publish What You Pay, an international campaign backed by a coalition of over 300 civil society organisations from more than 50 countries worldwide, our organisation advocates greater transparency in the management of revenues paid by the oil, gas and

> mining industries to governments in developing or transitional countries that are resource-rich. There is a growing international consensus that increased transparency is an essential step towards combating corruption, improving governance and promoting sustainable development in such countries.
>
> We call for country-by-country disclosure requirements to be incorporated into international accounting standards so that information on payments to individual governments is available in companies' annual financial accounts. Because we believe this issue to be of such importance to the extractive industries we are convinced that disclosure of country-by-country payments will be of benefit to users of financial statements in other sectors who need decision-useful information about the scale and location of all reporting entities' international activities.
>
> In our view – one shared by many other stakeholders – the publication of information on revenues paid by extractive industry operators and other companies to governments on a country-by-country basis is in the interests of all users of financial statements and the public at large. Both investors and civil society organisations in developed and developing countries are users of company financial statements. Information on payments to governments is vital for comparing the costs of production or operation in various countries. For civil society, greater disclosure will enhance their monitoring of revenue expenditure and budgetary processes more generally.

The IASB response to these critics reflected the prominence they give to decision usefulness rather than accountability. Thus, the IASB argued that IFRS 8 was not the place for discussion about the need for more transparent disclosures by the extractive industry and this was a matter better addressed by bodies such as the UN, IMF, the World Bank or regional development banks (IFRS 8, BC50; Gallhofer and Haslam, 2007).

The influence of those opposed to IFRS 8 was particularly felt in the EU. As discussed in Chapters 5 and 10, the EU endorses individual international standards and, if a standard is felt to conflict with the interests of EU corporations or users, the EU reserves the right not to adopt that particular standard. The European Financial Reporting Advisory Group (EFRAG) recommended that the European Commission should accept IFRS 8, which it initially agreed to do. However, in 2007, the European Parliament considered a motion[3] that it:

1 Is concerned about the Commission's proposal to endorse IFRS 8 through which it intends to incorporate US SFAS 131 into EU law and thus impose it on the listed EU companies;
2 Points out that such endorsement of IFRS 8 would imply moving from a regime which clearly defines how listed EU companies should define and report on segments to an approach that permits management itself to define operating segments as management finds suitable and which furthermore requires a lower level of disclosure and could thus lead to a lack of consistency in reporting;
3 Believes that the adopted standard should include a defined measure of segment profit or loss, as IAS 14 does;

[3]Motion b60157/2007 on Draft Regulation 1725/2003 as regards IFRS 8. UK Parliament EDM1369, 27/04/2007.

4 Highlights that the IFRS 8 standard, which does not require companies to use IFRS measures in their disclosure about operating segments, may have a negative impact on the comparability of financial information and thus may pose difficulties for users (e.g. investors);
5 Is concerned that the Commission is proposing, contrary to the principles of better regulation, to import into EU law an alien standard without having conducted any impact assessment;
6 Expresses its concerns about the impact that such a move would have for the EU preparers and users of financial statements and stresses the urgent need to conduct such an impact assessment;
7 Calls on the Commission to urgently carry out an in-depth impact assessment before endorsing the standard;
8 Stresses that, should the Commission fail to do so, Parliament will carry out its own impact assessment;
9 Instructs its President to forward this resolution to the Council and Commission, and the parliaments and governments of the Member States.

(European Parliament, Session document B6–0157/2007)

Similar concerns were also expressed in the UK parliament in an early day motion (EDM), although the motion went considerably further, explicitly echoing the concerns expressed by the PWYP campaign. An EDM is a formal motion laid down by an MP, to which other MPs can then add their names, showing their support. Although very few such motions are actually debated, they offer a way to publicize issues and to reveal their level of support. The following motion with 37 signatures appeared to be reasonably well supported:

> That this House finds International Financial Reporting Standard (IFRS) 8, concerning disclosure of operating segments by multinational corporations, totally unacceptable because it gives company directors carte blanche to decide what they disclose and how they disclose it and does not require consistency of disclosure either between periods or between companies and therefore fails to create a clear standard for disclosure to help investors, abolishes previous requirements for geographical disclosure and allows different accounting rules to be applied to segment information from that used in the rest of a company's financial statements; and therefore urges the UK Government and the European Commission to carry out their own urgent and in-depth impact assessments on IFRS 8 and require multinational companies to adopt, in addition to any segment data they disclose, full country-by-country disclosures of all activities in each geographical jurisdiction in which they operate, together with details of turnover, profits and taxes paid in each of those territories.
>
> (EDM 1369)

In the EU, after agreeing to carry out an impact assessment, the Commission issued its own questionnaires, gathering 207 responses. On the basis of these, coupled with consideration of IASB comment letters, academic research and a series of interviews, it endorsed IFRS 8 in November 2007, one year after it had been published but before its effective date according to the IASB (accounting years beginning on or after 1 January 2009). The Commission was undoubtedly worried about the possible

consequences for international standard setting of not endorsing the standard and this must have been an important consideration in its deliberations. However, it also argued that in general the respondents were in favour of the new standard:

> The majority of the respondents to our consultation believe that an information which allows looking at the performance of an entity the same way as management does . . . increases the transparency and the understandability of the management decision making process. This could help assessing the stewardship and performance of the management. Investors could be comforted to have the same kind of information as management, which is supposed to focus on key elements with high informational value.
>
> (European Commission, 2007, page 11)

18.3 Constraints on the benefits of segment reporting

18.3.1 Six types of constraint

Segment information is potentially very useful to financial analysts and other users in helping them to understand a company's past performance and to predict its likely future cash flows. However, the benefits might not materialize for at least six reasons:

1. segments too broad;
2. misleadingly artificial segments;
3. inter-connected segments;
4. group very diversified;
5. insufficient items reported; and
6. information already known.

These six constraints will now be briefly explained.

First, the lack of unambiguous rules for segment identification under the old standards (IAS 14 and SFAS 14) meant that companies may have deliberately reported relatively few broad segments, using the discretion granted to them to hide particularly sensitive information, so rendering the disclosures less useful than anticipated by the standard-setters. As noted above, discretion remains in the new standards because they depend on what the company decides to report internally. Secondly, under the old standards, if the company had created artificial segments that did not reflect the information upon which the company based its decisions, the users may have been misled.

The third constraint on the usefulness of segment reporting is that some companies are highly integrated, with segments very dependent upon each other, such that the success of any one segment depends upon the rest of the company and it makes little sense to consider that segment in isolation. Combining segment information with external information will be of little practical use in this case and the company should only be considered in its entirety. Similarly, if the company allocates significant amounts of common costs, the reported earnings of each segment will be highly dependent upon the cost allocation policy adopted.

The fourth reason why disclosures might not have been helpful is that a company may be very highly diversified industrially, so that there is little advantage in considering the potential risks and returns of operations in each separate industry because, when aggregated, they mirror the risks and returns faced by the entire economy of the country. Similarly, the company may be so well diversified geographically that it can be thought of as an international firm mirroring the world economy. The segments reported may encompass a range of countries and industries, owing more to historical accidents than to rational organizational structuring of current operations. This means that it may not be possible to combine the information provided with external information, which is industry- and country-specific, meaning that analysts are not able to successfully use this information to predict the future performance of the entity (Hussain and Skerratt, 1992). In addition, the segments may not be comparable to the segments reported by other companies.

Fifth, the items disclosed might not be the most useful ones. For example, users might want to know about profit excluding various items. They might be very interested in segmented liabilities, but not be told about them. Finally, irrespective of the segment reporting regime, the information may still be of little value to users if it lacks any element of surprise because all the information is, for whatever reason, already known to users before it is published in the annual report.

Because of these potential constraints on the usefulness of segment reporting, it is not sufficient simply to make a theoretical case for such reporting. The issue must be explored from a practical perspective and evidence must be sought regarding the usefulness of the actual segment disclosures made by companies. Three of the six constraints are connected to identifying the segments to be reported, which will now (in 18.3.2) be investigated in more detail, using research evidence. Then, Section 18.4 reports on the ways in which research has tried to assess the benefits of segment reporting.

18.3.2 Evidence about segment identification and the items disclosed

The early segment standards were criticized for giving companies too much discretion to choose their segments, and this was a major reason behind the introduction of SFAS 131 and then IFRS 8. This issue was explored theoretically by Chen and Zhang (2007). As discussed above, the new standards abandoned the 'risks and returns' approach used for determining LoB and geographical segments, in favour of the 'management' approach. Empirical research into the impact of SFAS 131 (which came into effect a decade before IFRS 8) suggests that it led to improved disclosures. It was expected that analysts would be more confident in their forecasts (Maines *et al.*, 1997). There is evidence that the amount of information disclosed for each segment and the number of segments disclosed increased (Herrmann and Thomas, 2000; Street *et al.*, 2000), and there was also an increase in cross-segment variability of segment earnings (Ettredge *et al.*, 2006). However, problems remained. The amount of *geographical* disclosure decreased, particularly the number of companies disclosing geographical segment earnings (Herrmann and Thomas, 2000), although more country-specific data were provided (Nichols *et al.*, 2000), with many companies using a materiality cut-off of significantly less than 10 per cent (Doupnik and Seese, 2001). In addition, a significant minority of companies still provided operating segment disclosures that

were inconsistent with the disaggregated information provided in the management discussion and analysis or with other parts of the annual review (Street *et al.*, 2000).

On the issue of ambiguous definitions of segments, Table 18.4 reproduces examples of geographic segments disclosed by US groups in 1979, and Table 18.5 reports the segments disclosed in 1998. It can be seen that, while SFAS 131 has probably reduced the problem of ambiguous segment definitions, it has not eliminated it.

Botosan and Stanford (2005) and Berger and Hann (2007) argued that, if SFAS 131 allowed companies less discretion than SFAS 14 over segment choice, then you would

Table 18.4 Examples of geographic segments identified by Fortune 500 US multinationals, 1979

- USA/Europe/Pacific
- USA/other western hemisphere/Europe and Middle East/Africa/Pacific
- USA/Europe and Africa/Americas and Pacific
- USA/western hemisphere/eastern hemisphere
- USA/Latin America/Europe/Canada
- USA/Europe/western hemisphere/Africa, Asia and Pacific
- USA/other western hemisphere/Europe/other eastern hemisphere
- USA/other North and South America/Europe and Asia
- USA/Europe, Africa and Middle East/Americas and Far East

Source: Gray, S.J. and Radebaugh, L.E. (1984) International segment disclosures by US and UK multinational enterprises: a descriptive study, *Journal of Accounting Research*, Vol. 22(1), pp. 351–360

Table 18.5 Enterprise-wide geographic disclosures by Fortune 500 US multinationals, 1998

Individual country	Number of companies	Country groupings	Number of companies
Canada	53	Europe	56
UK	43	Latin America	28
Japan	24	Asia/Pacific	25
Germany	22	Asia	11
France	19	Pacific	11
Brazil	10	Europe/Middle East/	
Mexico	8	Africa	10
Italy	6	Other Europe	9
China	5	Western Hemisphere	7
Spain	5	Other North America	4
Australia	5	Other Asia	4
Korea	4	Atlantic	3
Netherlands	4	Western Europe	3
Other countries	.34	Other groupings	22
	242		193

Note: 115 companies provided details of at least one individual country; 92 companies provided details of at least one country grouping.
Source: Doupnik, T.S. and Seese, C.P. (2001) Geographic area disclosures under SFAS 131: materiality and fineness, Journal of International Accounting, *Auditing and Taxation*, Vol. 10(2), pp. 117–138.

expect to see consistent changes (e.g. more segments) in reporting under SFAS 131. Botosan and Stanford argued that companies with segments in uncompetitive industries would have incentives not to disclose information on these as the abnormal profits (i.e. the difference between the reported segment profit and average industry profits) would be likely to be larger and the political costs of disclosure therefore higher. Looking at a sample of companies which reported no segments under SFAS 14 but reported segmentally under SFAS 131, they explored the importance of two variables: the industrial concentration ratios of primary or single pre-SFAS 131 segments compared to the hidden or newly disclosed post-SFAS 131 segments; and the profit performance of the new segment compared to the industry average. They concluded that SFAS 14 had, as expected, been used to hide relatively profitable segments that were operating in industries that were less competitive than a group's primary operations.

Crawford *et al.* (2012) examined the effects of IFRS 8 by looking at 150 UK companies before and after its implementation. They found that the average number of segments reported increased slightly, from 3.30 to 3.56, thus allaying fears that IFRS 8 would reduce the number of segments. However, the number of items disclosed fell. In particular, there was less disclosure of capital expenditure, of liabilities, and of assets by location of customer. Few companies used non-IFRS measures for segment reporting. Nichols *et al.* (2012) report broadly similar findings for a study of European (excluding UK) companies. Bugeja *et al.* (2015) look at Australian companies implementing IFRS 8. They also find and increase in the number of segments but a reduction in the number of line items disclosed.

Another relevant issue for any of the standards is that companies consider 'proprietary costs', i.e. the potential value of the disclosures to their competitors. For example, Edwards and Smith (1996) found that fears of disclosing competitively sensitive information was one of the three most important reasons for non-disclosure in the UK. The potential competitive harm will depend upon what other information must also be disclosed (Nagarajan and Sridhar, 1996) and the specific information being disclosed. For example, it depends not only on whether it is good news or bad news, but also on the similarities or differences between the potential segments. For example, Hayes and Lundholm (1996) argue that, if there is a high level of competition, companies are more likely to report segments if all segments have similar results, a view also supported by Harris (1998). The importance of competition is likely to depend also upon the form that it takes. Existing competitors may already be highly knowledgeable about the company and its performance, so there may be relatively little harm in disclosing segment information because it is not new information. In contrast, if there are low barriers to entry, potential entrants to the market will be more important and these companies will tend to know far less about the company and its activities. Disclosing information to these potential competitors might therefore be more harmful to the company.

Nichols and Street (2007) looked at the position under IAS 14 (as revised in 1997). As they explored disclosures under only one standard, the dependent variable was instead a 0/1 variable depending upon whether or not the company disclosed an industry segment for each industry that it operated in. The dependent variable was return on assets compared to the industry average. Country-specific control variables were included. Using data for four years, 1999–2002, they concluded that the evidence supported proprietary cost theory, with companies tending to hide segments if

they earn excess profits. While this supports earlier work by Harris (1998), who found that the operations in less competitive industries were less likely to be reported, the issue of exactly how proprietary costs affect disclosure is still unclear.

Berger and Hann (2007) argued that competitive disadvantage (or proprietary cost theory) suggests that firms would have used the discretion available under SFAS 14 to avoid reporting abnormally high profits. They also argued that agency theory suggests that companies would have also avoided reporting segments that reported abnormally low profits. In their first sets of 10-K reports under SFAS 131, companies had to restate the prior year SFAS 14 disclosures to the new rules. This allowed the researchers to look at companies which changed the number of segments reported. Using a logit analysis, they found clear support for the agency theory predictions. While some support was found for the effects of proprietary costs, the results were more mixed.

Bens *et al.* (2011) find that the aggregation of segments is greater when the agency and proprietary costs of separate disclosure are higher, and when firm and segment characteristics allow greater discretion in the application of SFAS 131's rules.

18.4 Assessing the benefits of segment reporting

18.4.1 Introduction

The benefits of segment disclosures have been examined using a number of different approaches. Some of the earliest studies simply asked users whether or not they wanted segment information. This may offer some insights, but potential users are unlikely to be able accurately to assess the usefulness of new information with which they are unfamiliar. They will also have an incentive to overstate its usefulness as they do not bear the costs of disclosure. More direct tests of usefulness are therefore required. These fall into three types: analysis of user decision-making; comparisons of the predictive ability of different types of forecasts; and stock market reaction tests.

Analysis of user decision-making is concerned with how decisions are affected by the provision of different types of information. These tests may be artificial, laboratory-type tests that give people different kinds of information and ask them to make various types of decisions. Alternatively, studies may look at the actual decisions made by users, including the accuracy of analysts' forecasts. Predictive ability tests compare the accuracy of mechanical or mathematically generated forecasts of sales, earnings or other accounting variables using consolidated information with similar forecasts based instead upon segment information. The final approach of testing stock market reactions generates results that are the least ambiguous with regard to the implications that can be drawn. They test to see if segment disclosures have an effect upon share prices or market risk measures. If such reactions exist, the information was somehow used and it must therefore have been useful. If, instead, segment disclosures had no measurable effect then it is concluded either that they are not used by stock market participants or that the information must have already been obtained from other sources. However, this does not, of course, imply that segment information has no value, since it may still be used by other report readers such as governments, pressure groups, trade unions or employees.

18.4.2 Studies of user decision-making

Various approaches have been taken to asking whether, and how, segment information is used. Perhaps the most interesting approach would be to look at the decision-making processes of users, the types of information they use, and the value of different types of information. Unfortunately, it is very difficult to gather accurate data on any of these questions and less direct approaches are therefore required. The simplest of these is to ask users what they do and what information they find valuable. However, this is seldom done, both because it is hard to find willing respondents and because it is difficult for them to describe accurately what they do or how valuable the individual items of information are. However, one example of such a study is that of Mande and Ortman (2002a) who looked at Japanese financial analysts, concluding that they perceived segment information to be useful despite misgivings regarding the definitions and consistency of the segments disclosed (see also Ashbaugh, 2002, for a discussion of the limitations of questionnaires of this type).

A more popular approach is therefore to look at the actual decisions made by the various types of users. One important user group is financial analysts who publish forecasts of expected corporate performance. While this is only one user group, there seems to be no reason to think that this group would be consistently different from others with respect to how useful they find segment disclosures. Forecasts made using segment data are therefore compared to forecasts made without access to segment data to assess whether forecasts are more accurate in those periods, or for those companies, for which segment information is available.

One of the earliest studies using this approach was that of Baldwin (1984) who looked at analysts' forecasts of the earnings per share of US companies after they first started to disclose LoB segment data. He found that these disclosures appeared to help analysts to make more accurate forecasts. Similar results were also found in later studies by Lobo *et al*. (1998), who also looked at LoB segment disclosures, and by Nichols *et al*. (1995), who instead looked at the impact of geographical segment disclosures on analysts' earnings forecasts.

More information on what types of segment data are most useful can be obtained if researchers artificially limit the available data that analysts can use. A number of studies have done this by presenting analysts with case studies containing particular types of segment disclosures. For example, Emmanuel *et al*. (1989) looked at the forecasts made by UK analysts when presented with specially constructed case data. Having found that the majority of analysts changed their forecasts in terms of both point and range estimates when they were presented with more segment data, the results clearly support the conclusions of the more direct US studies. Doupnik and Rolfe (1990) conducted an experiment which involved giving US analysts various types of geographic segment data. The information provided varied in terms of the number of segments and the extent to which they were similar or dissimilar to each other. They found that the perceived riskiness of the proposed investment was smaller when the number of segments disclosed was larger. More importantly, the segment disclosures were really only of benefit when the segments disclosed were perceived to be dissimilar from each other in terms of having different risk profiles.

The conclusion that the usefulness of segment disclosures depends upon the specific characteristics of the segment reporting rules, the segments disclosed and the

difficulty of making earnings forecasts is also supported by various studies of analysts' actual forecasts. For example, Hussain (1997) regressed forecast accuracy on company size, absolute change in earnings and the quality of segment disclosures. Looking at forecasts made in the UK he found that forecasts using segment data were more accurate for smaller companies and for companies that experienced a fall in earnings, a group of companies for which forecasts tend to be particularly inaccurate. However, perhaps surprisingly, the number of segments disclosed appeared not to affect forecast accuracy. In a later UK study, Kou and Hussain (2007) explored the impact of more corporate characteristics and arguably much better, more nuanced measures of segment disclosure quality. They found that forecast accuracy was enhanced if companies disclosed segments on a matrix basis, disclosed the differences between geographic markets and origins, disclosed finer geographic segments or disclosed industry segments that better reflected industry-wide performance. In contrast to this, they found that accuracy decreased as the number of segments increased, perhaps because of the costs associated with the analysis of multi-segment companies. Mande and Ortman (2002b) examined forecasts made following the introduction of a Japanese standard on segment reporting, which was particularly unpopular with companies. They concluded that the segment disclosures did not enable more accurate profit forecasts but did generate more accurate sales forecasts, though only for the most diversified companies.

Byard *et al.* (2011) studied the effects of the adoption of IFRS 8 on European companies They conclude that analysts' absolute forecast errors and forecast dispersion decreased relative to this control sample, but only for those mandatory IFRS adopters domiciled in countries with both strong enforcement regimes and domestic accounting standards that differed significantly from IFRS. Furthermore, for mandatory adopters domiciled in countries with both weak enforcement regimes and domestic accounting standards that differed significantly from IFRS, forecast errors and dispersion decreased more for firms with stronger incentives for transparent financial reporting.

18.4.3 Studies using researchers' forecasts

There have been several predictive ability studies in which the researchers create their own forecasts of company performance. This approach is based upon an implicit assumption that at least some market participants not only are capable of using, but actually do use, segment information in this way. Whether or not this is the case is not clear and, therefore, care has to be taken when drawing conclusions from these types of studies.

The first attempt to use LoB segment data for forecasting purposes was by Kinney (1971) who forecast the earnings of 24 companies. He used four models: two based upon aggregated data, one using segment sales information and the final model using segment sales and segment profit data. Kinney concluded that the most accurate forecasting model was the one which used LoB sales and profits. This model was significantly more successful than either of the consolidated models, but it was only marginally more successful than the model combining segment sales with a consolidated earnings margin. Although these results were promising, they may have depended crucially upon the particular sample chosen (in this case both small and

self-selecting, in that all the companies voluntarily disclosed segment data) and the models used (the specific models used were criticized by later studies). Therefore, before concluding that LoB segment disclosures are useful, further evidence is required using different samples and different models.

The next important study in this area was by Collins (1976) who increased the number of companies used to a random sample of 96 companies that disclosed LoB data after it was made compulsory in the United States. Actual sales and profits and first differences (the change from one period to the next) were forecast for 1968 to 1970, using seven models based upon consolidated information. Sales were also forecast using LoB segment sales multiplied by the expected change in sales of the relevant industries. For earnings, two segment models were used. First, the forecasted sales of each segment were aggregated to obtain a forecast of company sales and this was then multiplied by the prior year consolidated profit margin. Secondly, the forecasted sales of each segment were multiplied by the prior year profit margin for that segment and the resultant segment profit forecasts aggregated to obtain a forecast for the entire company. For sales, both actual and first differences, the segment model significantly outperformed six of the seven consolidated models. The segment profit-based forecasts were even more successful in that, for both the level and the first differences of earnings, the segment models were significantly better than all the consolidated models. In addition, as Kinney had found, the use of segment profit margins, rather than segment sales and consolidated profit margins, led to only a marginal improvement in predictive ability. Similar results have also been found when quarterly data was used to predict earnings (Silhan, 1983).

In a similar study using United Kingdom rather than United States companies, Emmanuel and Pick (1980) forecasted sales and earnings of 39 companies for 1973 to 1977. They reached similar conclusions when they found that segment-based sales and earnings forecasts were more accurate than a consolidated random walk model, which assumes that next year's sales or earnings will be the same as this year's. However, their results differed slightly from the US studies in that they found that the addition of segment profit did not lead to even a marginal improvement over forecasts based upon segment sales.

While these studies clearly support the conclusion that sales and earnings forecasts can be improved if segment sales data are used, they all ignore many company-specific factors. In particular, they ignore the number of segments reported and the size of the company. There is some evidence that forecasts increase in accuracy as the number of segments increases (Silhan, 1982). In addition, any gain in predictive power due to the addition of segment data is more common for smaller companies (Silhan, 1984). Indeed, only for smaller companies were segment-based forecasts always found to be more accurate, irrespective of the number of segments disclosed. The relative superiority of LoB-based forecasts is also likely to depend upon the specific industries in which a company operates. If it operates in industries whose growth rates mirror the growth pattern of the entire economy, then there should be little additional benefit in using industry-specific forecasts. Similarly, as discussed earlier, if a company is highly diversified industrially, the overall growth rate of the company is likely to mirror the growth in the economy as a whole. Using these types of arguments, Garrod and Emmanuel (1987) found evidence that the relative success of LoB-based forecasts did indeed appear to depend upon the diversification patterns of companies.

Less interest has been shown in the usefulness of geographical segment data. This is probably due to a variety of reasons. As discussed above, under both SFAS 14 and IAS 14 the main basis of segmentation was more often industrial (LoB) than geographical. It is also usually easier for users to combine LoB data with external information to generate forecasts than it is to combine geographical segment data with external data. For example, it is easy to obtain forecasts of growth rates for a large number of industries in the United States and to a lesser extent in the United Kingdom or other countries. These forecasts can then be combined with LoB data to obtain forecasts of segment growth rates. This assumes that either all sales are generated domestically or, if made abroad, the relevant growth rate is the same as that which applies to domestic operations.

If a similar approach is to be taken with geographical segments, then forecasts must be generated for the geographical segments disclosed. This presents a number of problems. External economic forecasts of GNP or GDP growth are generally available for individual countries only. However, if companies have not disclosed single country segments it is often not clear in which countries the company operates or the proportion of production or output that is attributable to individual countries.

When the segments disclosed cover a group of countries, some assumption must be made regarding the specific countries in which a company operates. In addition, a foreign subsidiary will operate in its own local currency and its results then have to be translated into the group's presentation currency (usually the parent's currency). Therefore, even if single country results are disclosed, the forecaster will need information not only on the expected growth rate of the individual country, but also on expected exchange rate changes. Despite these problems, there have been studies exploring the usefulness of geographical disclosures in both the United Kingdom and the United States. These have used slightly different methods for constructing their forecasts although they have some similarities. First, they need to choose a methodology for forecasting the expected growth of sales or profits in an individual country. As with forecasts based upon LoB data, the simplest initial forecasts are the random walk models, in this case models that assume that domestic GDP as well as exchange rates will remain unchanged, so expected sales or income are the same as last year's sales or income as reported in the parent's currency. More complex models assume that the growth in sales or earnings will mirror the expected change in each country's real GDP. Other models instead build in expected changes in exchange rates. Forecasts of economic data for individual countries are normally combined to produce a forecast for the segment by weighting each country that could possibly be included in that segment by the relative size of its GDP.

Behn *et al*. (2002) examined the impact of the move from SFAS 14 to SFAS 131 in terms of the predictive ability of geographic segment information. Three models were used: a random walk model that assumes no change in dollar-based figures, a perfect foresight model, that is, a model that assumes the change exactly mirrors exchange rate changes and GDP changes and a model based on actual forecasted changes in GDP and exchange rate changes. In each case, the errors for income and sales forecasts generated using data required by SFAS 14 and the data required by SFAS 131 were compared. As they expected, they found that forecasts based upon SFAS 131 were significantly more accurate. Also, as would be expected, these results were driven by the changes in accuracy with respect to US/other and country specific disclosures.

In contrast, for those companies that continued to disclose regional segments, the change in standard failed to lead to more accurate forecasts.

These results are as expected, given that SFAS 131 was designed to provide more useful information. However, the finding that segment-based forecasts failed to outperform consolidated-based forecasts is surprising not only because it casts doubt on the usefulness of geographic segment data, but because it conflicts with earlier US evidence. The models used by Behn *et al*. were based upon those employed in the earliest US study of geographic segment-based forecasts (Balakrishnan *et al*., 1990), which had concluded that geographic segment data appears to be useful for forecasting earnings. It also found that the available economic forecasts were, as might be expected, less than perfect. Thus forecasts using geographic earnings data and actual or *ex post* economic data were more accurate than forecasts using geographic earnings data combined with forecasts of expected GNP and exchange rate changes.

Similar conclusions that geographic segment-based forecasts tended to out-perform consolidated models were found in the United Kingdom. Roberts (1989) used a sample of multinational companies that disclosed both segment sales and segment earnings. The conclusions reached were very similar to earlier LoB studies. The segment-based models generally significantly outperformed the consolidated models. In addition, while the segment earnings-based models were generally more accurate than the segment sales-based models, the difference in forecast accuracy was not significant in most cases.

Further evidence on the usefulness of available economic forecasts has been provided by a number of studies. For example, Herrmann (1996) found that economic forecasts of exchange rate changes, GNP changes and inflation were all useful in predicting sales and gross profits but were not useful in predicting earnings. However, the findings of Johnson (1996) suggest that it is probably not sufficient to talk of the usefulness of geographic segment disclosures without considering the actual segments reported. This is because, when Johnson looked at the usefulness of forecasts of exchange rate changes, she found that the results were dependent upon both the countries and industries in which a company operates. This is not surprising because the impact of changes in economic factors such as inflation and exchange rate changes vary with the specific characteristics of a company. The industry in which it operates and its internal organizational structure will affect the extent to which a company can change its operating plans to minimize any unexpected adverse impacts or to take advantage of any unexpected beneficial impacts of changes in the economic environment facing the company.

18.4.4 Stock market reactions to segment disclosures

Many studies exploring the usefulness of segment disclosures have looked at stock market effects. These studies are of several types. Market reaction studies explore the impact of disclosures upon various market measures, in particular either market beta or cumulative abnormal returns. Other studies explore how the market prices different types of information, while a third category explores the impact of segment disclosures upon possible investment strategies. Like the other types of research above, the earliest studies tended to look at LoB disclosures, while later ones examined geographic disclosures and the most recent studies have tended to explore the impact of SFAS 131.

Looking first at market reaction studies, the results have generally supported the conclusion that the market finds segment data useful. The very earliest studies tended to look at the impact of segment information on market risk or companies' betas. For example, Simonds and Collins (1978) and Collins and Simonds (1979) found that disclosure of LoB data had the effect of significantly reducing risk. Prodhan (1986) examined UK rather than US companies and the disclosure of geographic segment information. Using interrupted time-series analysis, he found that changes in beta were significantly related to segment disclosures. In the period 1973 to 1977, those companies which had disclosed segment data (the treatment companies) had significantly higher betas than those companies which did not (the control group). After 1977, when both groups disclosed segment data, there was no difference in their betas. Similar results were also found when a rather larger group of US companies were examined in a later study (Prodhan and Harris, 1989).

An alternative approach is to examine the relationship between betas and accounting betas that are generated from the segment disclosures. Following the early work of Kinney (1972), Mohr (1983, 1985) used LoB data to do this, finding a significant positive linear relationship between the two risk measures, with the strongest association being between market beta and an accounting beta based upon LoB asset data rather than either LoB sales or earnings.

These conclusions are also supported by a rather different type of analysis carried out by Senteney and Bazaz (1992). Instead of looking at betas, they looked at the association between unexpected share price changes (or cumulative abnormal returns, CARs) and changes in annual consolidated earnings. They found that the association was weaker after companies disclosed geographic data following the US standard, SFAS 14. They concluded that the explanation for this lies in the better earnings predictions that the market could make once geographic data were available. Given the more accurate forecasts made possible by the disclosure of segment information, the surprise value of the annual report disclosures will be less and the share price reaction to these disclosures will therefore be smaller.

Rather than comparing the CARs of two groups of companies (those that did and those that did not disclose geographic data), various studies have looked at the relationship between market risk measures and either types of geographic segment data or types of geographic segment definitions (Boatsman *et al.*, 1993; Prather-Stewart, 1995; Pointer and Doupnik, 1996). For example, Prather-Stewart (1995) examined the association between CARs and unexpected geographic sales (in Asia, Europe, South America, North America and the United States) and the number of segments disclosed. In a similar study, Boatsman *et al.* (1993) found that all segments were significant, with the one exception of South America, while Prather-Stewart found that all regions except South America and Asia were significant. These findings suggest not only that foreign segment information is used by the market, but also that foreign profits or sales are capitalized at lower multiples than domestic or US sales or earnings. The one exception to this appears to be the United Kingdom, in that Boatsman *et al.* (1993) found that UK earnings were valued more highly than were US earnings. However, it is interesting to note that, in contrast, Garrod and Rees (1998) found, when exploring a sample of UK companies, that US-based operations were more highly valued than all other operations including UK-based operations.

Thomas (2000) also extended the work of Boatsman *et al.*, not only in terms of improving the methodology but also by extending the period examined, and found that geographic segment information appears to reflect information used by market participants for return intervals of three or more years. Again, segment earnings appear to be valued approximately in accordance with the risk and growth characteristics of each segment. Later work by Hope *et al.* (2008) looked at the impact of SFAS 131. They regressed unexpected stock returns on changes in domestic and foreign earnings and concluded that the quality of the segment disclosures helps to explain the results found by earlier studies, with the mispricing of foreign operations decreasing as the number of segments and the amount of disclosure of performance measures increase.

Further evidence on the impact of SFAS 131 is found in Ettredge *et al.* (2002, 2005). The earlier study looked at the market's reaction to the introduction of SFAS 131, while the later one looked at whether market participants could use segment disclosures to generate more accurate estimates of future earnings. Initially the researchers found that SFAS 14 encouraged larger companies and those that operated in more highly concentrated industries to disclose fewer and therefore larger or less disaggregated segments. They then found that the market also anticipated that SFAS 131 would impose significant costs on these affected firms. It is likely that these costs would arise as these companies would have in the future to disclose more information and accordingly would be expected to suffer competitive harm. The later study was based upon the argument that, if segment information is useful to market participants, it should allow them to make better predictions of the future performance of the company and in turn better investment decisions. There should therefore be a stronger relationship between current year market returns and next year's consolidated earnings, or what they termed the forward earnings response coefficient (FERC). As expected, they found that FERC increased significantly when SFAS 131 was introduced both for multi-segment companies and for companies that first reported under SFAS 131. However, in contrast, FERC did not change for companies that were single segment companies under both SFAS 14 and SFAS 131.

Hope *et al.* (2009) found that the increase in the number of geographic segments and the disclosure of geographic earnings measures, caused by SFAS 131, led to a better appreciation by the market of the value of foreign earnings.

Rather than looking at the impact of segment disclosures on risk or return measures, an alternative approach is to compare the returns generated by two investment strategies, one based solely on consolidated data and the other based upon segment data. The first of these studies was by Collins (1975). His sample consisted of 92 companies following the introduction of the 10-K disclosure requirements in the United States, which required companies to disclose prior period LoB data. The investment strategy consisted of buying shares if segment-based forecasted earnings exceeded those from consolidated models, and selling short if the reverse held. The segment-based strategy yielded significant gains in both 1968 and 1969 of between 1.44 per cent and 1.51 per cent per month for companies that had not voluntarily disclosed segment information. In contrast, insignificant gains were made for those companies that had previously voluntarily disclosed LoB sales data, implying that the market had used this segment information when it was first disclosed.

Finally, a number of studies have explored the usefulness of quarterly segment data. This is an interesting issue as one of the major arguments against mandating

the use of the new US or IFRS rules for segment disclosures was the fear that this would make it too time consuming or expensive for quarterly segment reporting. The evidence seems to support the usefulness of quarterly segment data in terms of both impact upon information content (Hossain and Marks, 2005) and analyst following (Botosan and Harris, 2000).

SUMMARY

- The growth of large diversified companies has presented problems for users of financial reports, especially in terms of assessing the future cash flows of a company and the risk or uncertainty associated with those cash flows. Segment reporting goes some way towards meeting the information needs of investors and other users.
- Not all companies willingly disclose adequate segment information. Many argue that the costs of disclosure outweigh the benefits. The alleged costs include the costs of compiling, processing and disseminating information as well as competitive disadvantage.
- Given the lack of adequate voluntary disclosures, accounting regulators have increasingly required companies to disclose segment information. US and IFRS requirements have been built up over a number of years, culminating in accounting standards requiring extensive disclosures.
- Concern has been expressed that senior management have been given too much discretion to choose the appropriate segments. Such discretion may have been used to reduce the amount of information provided or even to provide potentially misleading information. Given these considerations, the FASB and the IASB have made changes to their segment standards and both now use the operating structure of the enterprise as the basis for determining the primary basis of segmentation.
- Segment reporting has been a rich field for academic research. Studies have been made of how analysts use segment data, of whether researchers can make better forecasts with such data and of whether share prices change.
- The results of predictive ability studies have shown that both LoB and geographic segment data are more useful than consolidated data for the prediction of earnings. While all studies appear to agree that segment sales data are useful, there is less agreement over whether or not there are additional benefits to be gained from the disclosure of segment earnings. In most studies, even when it was found that predictions were more accurate if they were based upon segment earnings instead of segment sales data, the differences in accuracy were relatively small and often not significant.
- There is also evidence that the accuracy of forecasts is dependent upon the specific industries in which a company operates, and the accuracy of the forecasts is greater for smaller companies and for companies that disclose more segments.
- Studies that looked at the market reaction to segment data also clearly suggest that both LoB and geographic segment data are useful to the market. Specifically, segment disclosures are significantly associated with CARs and generally result in a decrease in market beta, at least in the United States and United Kingdom equity markets.

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QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

18.1* Explain why standard-setters have difficulty in drafting segment reporting standards.

18.2* How could one demonstrate that the benefits of segment reporting outweigh the costs?

18.3 'Research shows that line-of-business reporting is much more useful than geographical segmental reporting.' Discuss.

18.4 Using segment reporting as an example, explain how standard-setters could use research when planning to impose extra disclosure requirements.

18.5 A number of companies voluntarily prepare segment reports beyond what is required by regulation. Given the difficulties faced by regulators in developing rules for segment reporting, is regulation really necessary and/or desirable?

18.6 Discuss to what extent segment reporting is beneficial to different user/stakeholder groups.

18.7 Discuss the view that IFRS 8 ignores the needs of many stakeholders.

Part VI

MONITORING AND ENFORCEMENT

19 International auditing

Graham Gilmour and Diana Hillier[1]

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OBJECTIVES

After reading this chapter, you should be able to:

- explain why and how auditing has been internationalized, with particular reference to the role of multinational enterprises (MNEs), international capital markets, international accounting networks and harmonization;
- explain why and how the International Auditing and Assurance Standards Board (IAASB) has become the principal setter of international standards on auditing (ISAs);
- discuss the role of ethics, technical standards and quality control in international auditing;
- describe the stages of the international audit process;
- discuss the audit expectations gap in an international context.

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[1]Versions of this chapter in some earlier editions were co-authored by Jan Klaassen of the Free University of Amsterdam and Jan Buisman of PricewaterhouseCoopers.

19.1 Introduction

'Auditing' as an activity was defined by the American Accounting Association in *A Statement of Basic Auditing Concepts*, published in 1973, as:

> a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

In a financial statement audit, the 'assertions about economic actions and events' are attributes of the financial information presented in the financial statements that portray an entity's financial position, financial performance and cash flows. Transactions and events are recorded as accounting data, stored in information systems, and then used to produce financial reports. Such data are the representations of economic actions, for example transactions or events such as purchases and sales, business combinations, or changes in fair values of assets and obligations.

Auditing is a systematic process, which involves steps such as:

- acceptance and defining the terms of engagement;
- planning and risk assessment;
- gathering evidence;
- reporting.

The process outlined above could be used for a much wider variety of engagements, for example reporting on non-financial information. There are currently many projects around the world looking at how companies report on types of non-financial information (such as sustainability reporting, or a company's key performance indicators), and how auditors can provide attestation or assurance services on that information. In the context of this chapter, however, we will discuss only the audits of financial statements. In particular, we will look at international aspects of this type of auditing. In Chapter 20, audit is seen as part of the enforcement system of financial reporting, and the monitoring of auditors is discussed.

Public accountants (or external auditors) are those who independently perform audits of financial statements in order to be able to express an opinion on whether those statements are fairly presented (or give a true and fair view) in accordance with the applicable financial reporting requirements. External auditors are generally appointed by companies (in many jurisdictions, by their audit committees), to conduct the audit for the benefit of the company's shareholders, but also used by other external stakeholders, such as investors and creditors. However, the functions of external auditors vary by country. As mentioned in Chapter 8, in the United States, as well as in most other Anglo-Saxon countries, the opinion of the external independent auditor is included with the published financial statements to add credibility to the financial statements used by investors and creditors. However, as indicated for the individual financial statements of German companies in Chapter 14, financial reporting and tax reporting are closely connected. As a consequence, the audit in Germany was historically focused more on legal acceptability and acceptability for tax purposes than on fair presentation for the benefit of external stakeholders.

Nevertheless, Vieten (1995) suggests that the comparison between Anglo-Saxon countries and Germany was never so stark as was often presented. As IFRS is designed to achieve a fair presentation, the adoption of IFRS in Germany has brought further alignment.

The international aspects of auditing refer to: (i) the harmonization of auditing standards and rules across countries, and (ii) the practice of auditing the financial information prepared by multinational corporations, based on one or more sets of auditing rules.

In the days when companies largely confined their activities within national borders and when shareholders of a company were largely domiciled in its country of operations, auditing philosophies and techniques were determined by auditors in a national context and by the actions of national accountancy bodies that had built their own traditions. Consequently the role of auditors and their responsibilities towards the stakeholders of a company – i.e. shareholders, investors, management and other interested parties – developed within the context of societal developments in each individual country. These influences are also reflected in the education of auditors. In certain countries, prospective auditors have received their education mainly in the economics or business departments of universities, while in others a large part of the auditors' education has taken place through on-the-job training supported by formal training in special educational institutions.

In addition, as a result of the variations in the historical purposes of financial reporting in different countries, the auditing profession historically played different roles in relation to company management, banks and investors and the tax authorities. In this chapter we deal only with the activity of independent auditing for the purpose of expressing an opinion to shareholders on the published financial reports of companies. Other types of auditing, for example tax auditing, internal auditing and auditing within governmental organizations, remain outside our scope.

The internationalization of auditing started when MNEs began preparing consolidated financial statements. Such statements normally needed to be based on one set of accounting principles. In order to achieve this, a head office had to instruct subsidiaries on the accounting principles to be applied. In order to be able to express an opinion on the group's consolidated financial statements, the auditors of the parent company similarly needed a common set of standards to ensure the quality of the subsidiaries' audits. It gradually became apparent that the international auditing profession needed to harmonize the working methods of auditors in different countries and to develop international auditing standards.

Factors that have contributed to the internationalization of auditing include:

- the emergence of MNEs;
- the increasing internationalization of capital markets;
- the growth of international accounting firms, with common approaches to audit methodology, training and quality review;
- the convergence around common international frameworks for accounting and audit.

In the next section we will discuss these factors. Section 19.3 then deals with the role of international bodies, including IFAC, in promoting the promulgation

of international auditing standards. Section 19.4 describes the international audit process in more detail. As discussed in Chapter 20, audit can be seen as part of the enforcement system of financial reporting.

19.2 Reasons for the internationalization of auditing

19.2.1 The role of multinational enterprises

The emergence of MNEs, as discussed in Chapter 1, has to a large extent triggered the internationalization of auditing. Generally, when an MNE prepares its consolidated financial statements, it will need an audit of those statements on the basis of the financial reporting and auditing standards of the home country of the group's head office. The MNE will have foreign operations which therefore need to be audited for this purpose; in addition there may be local requirements for audits of the separate financial statements of the foreign operations themselves.

So, the auditors of the consolidated statements (the 'group auditor') needed a way to manage the quality of the audits of the financial information. Group auditors provide instructions to auditors in the countries where the subsidiaries are located ('component auditors') concerning the requirements for the audit work the group auditor needs to be performed in order for the group auditor to obtain sufficient appropriate audit evidence on which to base the opinion on the group financial statements and report to top management on a worldwide basis. Group auditors, therefore, have a stake in the quality of local audits, which are performed on the accounts of subsidiaries of the multinational corporations. Central corporate management also wants to be sure that the local audits are sufficient to lend credibility to the information from the local management of subsidiaries. This requires local auditors to perform audits in such a way that these are satisfactory to central management as well as to the group auditor of the consolidated financial statements. These developments led to the introduction of new auditing techniques in certain countries and new methods of communication with local and central management.

The emergence of MNEs has also triggered developments in the roles of audit firms and has led to international mergers among firms, partly in order to enable them to remain independent from their big clients. Furthermore, very large companies can only be properly served by large accounting firms, with the appropriate technical and geographical capabilities.

In addition, it is important that the size of audited companies not be allowed to become a threat to independence of its auditor, which could be a risk if any particular audit is a substantial part of the audit firm's portfolio.

In this respect it is important to note that accounting firms have tried to continue to serve their multinational clients as those companies have grown and extended their activities to foreign countries. Some firms have done this by establishing offices in the countries where their major clients are located; Post *et al.* (1998) examine this process for the large Dutch audit firms. Other international firms have merged with local audit firms in order to maintain their ability to serve their clients worldwide. Either way, this has enabled the audit firms to suggest to their multinational clients that one

audit firm could perform all the audit work in all or most of the countries where the multinational corporation is located. This has led to the centralization of certain decisions on the extent and depth of the audit worldwide and on the priorities to be set (for instance, materiality levels to be used, which may result in limited reviews to be performed on minor subsidiaries, etc.). Also, discussions on audit fees worldwide are conducted in the context of using the services of one audit firm throughout the world.

As mentioned above, in addition to the need for audits for consolidation purposes, there is sometimes also the need for statutory audits of local subsidiaries. In such cases, the audit process for the statutory audit will be combined with that for consolidation purposes. As the harmonization of accounting has not yet reached the state that one set of accounting principles is also used to prepare statutory financial statements in all the countries where a multinational company operates, national accounting rules often prevail for statutory audits. So, in many cases where the audit process has been internationalized, this takes place in conjunction with maintaining the practice of applying national rules for the statutory financial reporting of local companies.

19.2.2 Demand for international auditing from international capital markets

The demand for international audits can also be explained to a certain extent from the point of view of users of financial statements of those companies for which financing is arranged on international capital markets. For investors in international capital markets, the audit report and high quality of audit work are important to justify the credibility of the financial information that is used as an input to investment decisions.

In international capital markets, investors (including creditors) are faced with capital demands from foreign companies whose published financial statements are drawn up in accordance with foreign laws and regulations. To some extent, additional disclosures satisfy the need for comparable information. In some markets, regulators require a lot of additional information. In order to be able to rely on financial information reported by foreign companies, not only is the extent of disclosure important, so is the quality of the audit. As a consequence, from the point of view of the regulators of capital markets and of investors in foreign equity and debt instruments, it is important that the level of assurance provided by the audit report and the quality of the audit performed are in accordance with the expectations of the markets where the capital is raised. In order to achieve such a quality, the foreign auditors need to be familiar with the auditing and reporting requirements of the country where the foreign capital market is located and should meet those requirements when auditing financial statements to be filed abroad. In some jurisdictions, auditors must be licensed in that jurisdiction, and/or registered with the external audit regulators, in order to take responsibility for and sign the audit report on financial statements filed or issued in that jurisdiction.

The wording of the audit report is important for the effective communication of the auditor's opinion. There have been differences between the wording of auditors' opinions among countries, taking into account the differences in emphasis on 'true and fair' (Nobes, 1993) and the importance attached to financial statements being in accordance with laws and regulations. In order to communicate properly in international capital markets, there is a need for a more or less uniform approach to the auditors' opinions expressed in the audit reports.

The International Organization of Securities Commissions (IOSCO) has taken an interest in removing barriers for international capital markets (see Chapter 4). It has therefore had an interest in the importance of ISAs to achieve uniform quality levels of audits and to promote effective international communication through audit reports. As noted in Section 19.3, IOSCO has monitored closely the development of ISAs to determine whether these should be endorsed for use for cross-border listing purposes, and is also a member of the Monitoring Group, which provides linkage between the international audit-related standard-setters and the regulatory community.

19.2.3 The role of international audit networks

Internationalization of auditing has largely taken place within international audit firms. During the past few decades, many local audit firms have merged into international groups, as shown in Table 19.1. There were four very big mergers between international audit firms during the 1980s and 1990s, resulting in the emergence of five (now four) very large international firms. (The revenue figures in the table do not exhibit a uniform growing trend owing to the disposal by some firms of their consulting practices.)

The most important international audit firms have grown from their home base, either in the United Kingdom or the United States. As far as their organizational form is concerned, most of them operate as international networks of member firms, often sharing common technical and operating standards, methodologies, training and technology. However, each national member firm is a separate and independent legal entity.

The international character of all the big audit networks is evident from:

- an international approach to auditing;
- international quality-control systems;
- product developments;
- international marketing and communication strategies.

Table 19.1 Growth and mergers of large international auditing firms (revenues in US $bn)

	1992	2000	2010	2014
Arthur Andersen	5.6	8.4	–	–
Deloitte (formerly Deloitte Haskins & Sells and Touche Ross)	4.8	12.5	26.6	34.2
EY (Ernst & Young, formerly Arthur Young and Ernst & Whinney)	5.7	9.2	21.6	27.4
KPMG (formerly Peat Marwick and Klynveld Main Goerdeler)	6.2	13.5	20.6	24.8
PwC (PricewaterhouseCoopers, formerly Coopers & Lybrand and Price Waterhouse)	9.1	19.6	26.6	34.0

Sources: Prepared by the authors from *International Accounting Bulletin*, December 1992, December 2000, December 2010; *Accounting Today*, March 2011; and the firms' annual reports of 2014. Andersen and Ernst & Young revenue figures for 2000 reflect the disposal of the consulting parts of those firms, otherwise figures would have been higher. No revenue figures are presented for Andersen for the final periods because of the cessation of the business in 2002.

In order to manage an international approach to auditing, audit firms and networks generally develop a single audit methodology, in which a common approach and often specific steps are defined; for instance, descriptions of the planning process, the process of evaluating risks, the approach to testing (e.g. substantive procedures – obtaining evidence through either analytical procedures or tests of details – or tests of controls to evaluate the operating effective of the entity's controls). A description of the process of reporting and communication of the outcomes of the audit is also part of such an international audit process.

The international approach to auditing serves two main purposes:

1 Multinational clients are assured that, all over the world, members of the same audit network will apply a common set of policies and procedures to ensure the quality of the audit.
2 Consistency of the main elements of the audit process on an international scale gives the global networks of audit firms a common framework to manage audit quality across their networks, as well as enabling them to increase the efficiency and effectiveness of the audit process worldwide. A common audit approach worldwide also facilitates communication on technical issues, such as the assessment of the risk of material misstatement and level of materiality to be taken into account.

Through the use of an international approach to auditing, some cost savings can be achieved because audit programmes can be tailor-made to what is needed for the group audit, which will ensure that the level of detail applied in auditing certain subsidiaries can be tailored to what is needed to obtain the audit evidence needed for purposes of the audit opinion on the consolidated group financial statements. However, to the extent that local statutory audits are mandatory, and to the extent that regulation differs in each of the territories in which the audited company has major operations or in which it raises capital, such cost savings may be less.

One other advantage of internationalization is that audit networks can more easily exchange personnel between countries than if a different methodology were applied in each country, and this enhances efficiency. Furthermore, an international approach can help the auditor to set priorities concerning the level of attention paid to certain risks worldwide.

Although the approach to the *audit* may be internationalized within audit networks when auditing multinational clients, this is not yet the case for accounting. Of course, a multinational client has to apply accounting rules that are valid in the country in which the parent company is located. For consolidation purposes, all subsidiaries have to comply with the policies used by the group for valuation and disclosure. However, most subsidiaries also have to prepare local financial statements applying local accounting principles.

In order to perform international audits, sufficient people within local offices of the international accounting networks have to be familiar with accounting rules applied in certain foreign countries. For example, to audit foreign subsidiaries of US multinational enterprises, the US GAAP are used by local audit offices of the big accounting networks in many countries. Many multinational companies now apply IFRS, partly as a result of the requirement for all EU-listed companies to prepare their

consolidated accounts in accordance with IFRS. The major accounting networks have therefore developed programmes to train their staff in these internationally used accounting frameworks.

International product development is an important tool for international audit networks. Apart from the audit process, the networks develop software for international use and establish global groups and/or centres of excellence, for example to be able to participate in advising clients on listings on international stock exchanges, and to advise on international mergers and acquisitions.

An important characteristic of the internationalization of auditing is the establishment of international quality-control criteria within the big international accounting network firms. Quality control takes place at three levels: client engagements, offices and the firms in each individual country. Through the systems of quality control, an international network of firms can establish that its national member firms have common policies and methodologies to ensure work of a high quality. As discussed in Section 19.4.4, the quality measures taken by the large firms have now been formalized in the International Standards on Quality Control (ISQC). An important aspect of the quality management system is monitoring reviews of audit files for a selection of audits performed. Another way that networks are able to support quality is to station expatriate personnel in certain countries to enable parent companies and their auditors to communicate effectively on the audit of local subsidiaries.

Another important aspect of international quality control is the need for international education of the technical personnel of the audit firms. In order to properly introduce new techniques and new support systems, and also to guarantee a certain level of familiarity with the accounting rules of multinational clients, much internal education and training is given. Most of it is done on an international scale as this enables companies to achieve economies.

The Forum of Firms was launched in 2001 as a significant step by IFAC and the large network firms to increase the contribution of the firms to the development of professional standards and to give greater emphasis to audit quality. The objective of the Forum of Firms is to promote consistent and high quality financial reporting and auditing practices worldwide – bringing together firms that perform transnational audits and involving them more closely with IFAC's activities in audit and other assurance-related areas. Member firms need to observe the Forum's membership obligations which, with respect to transnational audits, commit firms to:

- maintain appropriate quality-control standards in accordance with International Standards on Quality Control issued by the International Auditing and Assurance Standards Board (IAASB) in addition to relevant national quality-control standards, and conduct, to the extent not prohibited by national legislation, regular globally coordinated internal quality assurance reviews;
- have policies and methodologies for the conduct of such audits that are based, to the extent practicable, on ISAs;
- have policies and methodologies which conform to the IFAC Code of Ethics for Professional Accountants and national codes of ethics.

As of July 2015, there were 27 international network firms that had indicated their compliance with the Forum's membership obligations and hence were full members of the Forum.

Table 19.2 Audit market share of top 100 companies, 2013

	% of audits	% of fees
PwC	35	43
EY	28	19
Deloitte	22	23
KPMG	14	15
Others	1	0

Source: Prepared by the authors from information in FT Global 500.

The above-mentioned aspects show that it is generally advantageous for MNEs to hire international audit firms. Table 19.2 shows the market share of audit firms in 2013, in terms of numbers of audits and percentage of fee income, of the world's largest 100 companies by market capitalization. Research confirms that auditor size is associated with disclosure transparency of auditees (Han *et al*., 2012). For a more general review of research on audit quality, see Francis (2004).

19.3 Promulgating international standards

19.3.1 Introduction

When an auditor of a group expresses an opinion on the consolidated or group financial statements, the auditor must obtain sufficient appropriate audit evidence in relation to the consolidation process and the financial information of the components to have a reasonable basis on which to form the group audit opinion. Under the ISAs, the group engagement partner is responsible for the direction, supervision and performance of the group audit engagement to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements – whether the audit work is performed directly or by other auditors.

In order to be able to accept such responsibility, the group auditor has to ensure that the work performed and audit evidence obtained at component level is sufficient to support the audit opinion on the group as a whole. This involves:

1 Obtaining an understanding of the group, its components and their environment sufficient to be able to identify components that are likely to be significant components (whether by size or because there are risks of material misstatement at the group level).

2 If the group engagement team plans to request a component auditor to perform work on the financial information of a component, obtain an understanding of the component auditor (for example, the component auditor's independence and competence, as well as the ability of the group auditor to be sufficiently involved in the key judgements and work performed by the component auditor).

3 Determining the work to be performed on component financial information that is significant due to size or risk (which could be an audit of the component financial information; an audit of one or more account balances, classes of transaction or disclosures; or specified audit procedures in accordance with the ISAs), and the work needed to obtain additional evidence needed on the group.
4 Being involved in the work performed by component auditors as is considered necessary in the circumstances. Depending on the circumstances, this may include ongoing discussion with the component audit team regarding key judgements (such as risk assessment), reviewing the audit documentation received and when necessary the component audit team's working papers, and attending closing meetings.
5 Obtaining the necessary communications relevant to the group engagement team's conclusion with regard to the group audit.
6 Evaluating the sufficiency and appropriateness of audit evidence obtained.

Because an international group consists of legal entities in various countries, the financial statements of each component of the group may have to be audited both in accordance with the local regulations prevailing in the country of registration and in accordance with any requirements of the group auditor. It is self-evident that it would be in the interest of all concerned if there were no such differences in audit requirements. This is the reason for various attempts to achieve harmonized auditing standards on a worldwide scale.

19.3.2 International standard-setters

Setting standards at an international level requires a body that has the authority to do that. Such supranational bodies are created by governments or by regional or international organizations within the accountancy profession. The most significant body involved in international audit standard-setting is the International Federation of Accountants.

International Federation of Accountants

The IFAC was founded in 1977. IFAC is a non-profit, non-governmental and non-political organization of accountancy bodies. Membership is open to accountancy bodies recognized by law or consensus within their countries as being substantial national organizations of good standing within the accountancy profession. At present over 150 accountancy bodies in more than 100 countries are members of IFAC. The broad mission of IFAC is:

> To serve the public interest by: contributing to the development, adoption and implementation of high-quality international standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants; promoting the value of professional accountants worldwide; and speaking out on public interest issues where the accountancy profession's expertise is most relevant.

IFAC's Council consists of one representative from each member body. The Council, which convenes once a year, elects the Board. The Board, comprising

22 members from around the world, has the responsibility for implementing the work programme of IFAC, which is carried out by smaller working groups or committees. IFAC has a number of standing committees or boards, including those responsible for setting professional standards in the fields of education, ethics, auditing and assurance, and public sector accounting.

The IAASB, which succeeded the International Auditing Practices Committee (IAPC) in 2002, is the most significant of the committees. It develops pronouncements on auditing and reporting practices (ISAs). IAASB has the authority to issue pronouncements without the approval of the IFAC Board, but does need to ensure that the Public Interest Oversight Board (PIOB) is satisfied that appropriate due process has been followed. The due process includes the issue of exposure drafts, which allows the public – including investors, regulators, national accountancy bodies and other stakeholders – a period in which to comment on them. Both the exposure drafts and the final pronouncements require the affirmative vote of at least two-thirds of the members. IAASB also issues standards on review engagements (ISREs), assurance engagements other than audits or reviews of historical financial information (ISAEs) and other related services (ISRSs), as well as on quality control (ISQCs)

IFAC is an independent private sector organization. However, the work of its standard-setting boards has since 2005 been overseen by a PIOB, as will now be explained. In late 2003, IFAC, with the support of member bodies and international regulators, approved a series of reforms to increase confidence that its standard-setting activities are properly responsive to the public interest. These included: a more transparent 'due process' for standard-setting; greater public and regulatory input into those processes; regulatory monitoring; and public interest oversight. The PIOB was officially established in February 2005.

The PIOB, comprising ten members appointed by regulatory organizations (the Basel Committee, the European Commission, IOSCO, the International Association of Insurance Supervisors and the World Bank), oversees standard-setting activities in the areas of audit and assurance, ethics and independence and education. It also oversees the member body compliance programme. The PIOB issues annual public reports on its oversight activities. As mentioned earlier in the chapter, the Monitoring Group of regulatory organizations (comprising those same organizations that nominate the PIOB members, plus the Financial Stability Board) commenced a review of the activities of IFAC's public interest standard-setting boards and the PIOB. This may result in changes to these arrangements in due course.

Following a review in 2001 of the structure, responsibilities and due process of the former body, the IAPC, the membership of IAASB draws on a wider range of experience. The number of public interest and non-practitioner members has progressively been increased, with the aim of achieving an equal balance of practitioner and non-practitioner input. Although the number of members from the profession has reduced, IFAC and the PIOB remain committed to ensuring a significant degree of practitioner input. The 18-person board, including the Chair and Deputy Chair, presently comprising practitioners and non-practitioners, of whom no more than nine are practitioners and no less than three are public members. A public member is an individual who satisfies the requirements of a non-practitioner and is also expected to reflect, and is seen to reflect, the wider public interest. Not all non-practitioners are therefore eligible to be public members. The three public members may be members

of IFAC Member Bodies. Nominations are open and no organization is guaranteed a seat at the table. The Chair is an independent full-time position. The Deputy Chair is selected from among the other Board members and appointment as Deputy Chair does not imply that the individual concerned is the Chair-elect.

In addition to the authoritative standards, IAASB issues guidance intended to provide practical assistance to auditors known as International Audit Practice Notes (IAPNs). In the context of the recent global economic crisis, IAASB has also issued staff publications, including Audit Practice Alerts on important and timely topics, such as 'Challenges in Auditing Fair Value Accounting Estimates' (October 2008) and 'Auditing Considerations in Respect of Going Concern' (January 2009). These alerts are not intended to set new standards or requirements, but to emphasize key relevant elements of existing pronouncements: hence they are not subject to the normal extensive due process steps.

Although harmonization of standards is easily achieved if standards are set at the lowest common denominator, this is not the policy of the IAASB and other IFAC standard-setting bodies. The standards and guidance are set at the level that experienced accountants view as the best that should be achieved by the profession. Although IAASB representatives may be nominated by particular constituencies, they are expected to work and vote towards the achievement of standards that are in the public interest.

Historically, ISAs have been less detailed than US GAAS. Beginning in late 2004, the IAASB began a project (commonly referred to as the 'Clarity project') to re-examine the structure of its standards. Important considerations included the extent to which the standards contained explanatory guidance as well as requirements, and the language used to describe steps that are expected to be performed. The project involved wide consultation with stakeholders, as the decisions taken shaped ISA standards at a critical point in their development – when they were being considered for endorsement by the EU and while the possibility of greater convergence of standards (particularly US standards) was being assessed. The Clarity project was completed in February 2009 when the PIOB approved the final batch of standards for release. The 36 updated and clarified standards were first made applicable for audits for financial periods beginning on or after 15 December 2009. Rather than introduce the new standards piecemeal, the intention was to make them all effective as of the same date so that they could be adopted as a complete set with appropriate lead time. A list of ISAs in Clarity format as contained in IFAC's 2010 Handbook is shown in Table 19.3.

IFAC itself has no authority to require that its pronouncements are adhered to, as it has no jurisdiction over individual accountants. However, national professional accountancy bodies, which are the members of IFAC, do. For this reason, a member body undertakes to subscribe to the IFAC Constitution and abide by a Statement of Member Obligations which includes a requirement to demonstrate how they have used best endeavors to implement the ISAs (recognizing that in an increasing number of countries, national audit standard-setting and regulation of the audit profession are now undertaken independently of the profession). In many countries, ISAs have been adopted as the national standards, and they have been translated into several languages.

As of 15 May 2015, 106 jurisdictions assert to either using the clarified ISAs, or commit to using them in the near future, including most major capital markets (outside of the US listed market) and the vast majority of EU Member States (although formal adoption of the European Commission itself remains elusive). In June 2009,

Table 19.3 International standards on auditing

Subject matter numbers and ISA document title	
200–299	**General Principles and Responsibilities**
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
210	Agreeing the Terms of Audit Engagements
220	Quality Control for an Audit of Financial Statements
230	Audit Documentation
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
300–499	**Risk Assessment and Response to Assessed Risks**
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risks
402	Audit Considerations Relating to an Entity Using a Service Organization
450	Evaluation of Misstatements Identified during the Audit
500–599	**Audit Evidence**
500	Audit Evidence
501	Audit Evidence – Specific Considerations for Selected Items
505	External Confirmations
510	Initial Audit Engagements – Opening Balances
520	Analytical Procedures
530	Audit Sampling
540	Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
560	Subsequent Events
570	Going Concern
580	Written Representations
600–699	**Using the Work of Others**
600	Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)
610	Using the Work of Internal Auditors
620	Using the Work of an Auditor's Expert
700–899	**Audit Conclusions and Reporting**
700	Forming an Opinion and Reporting on Financial Statements
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
710	Comparative Information – Corresponding Figures and Comparative Financial Statements
720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
800	Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

IOSCO issued a statement welcoming the completion of the IAASB's Clarity project and endorsing the replacement of the previous ISAs with the new standards. IOSCO noted that it encourages securities regulators to accept audits performed in accordance with the clarified ISAs for cross-border offerings and listings, recognizing that the decision on whether to do so will depend on a number of factors and circumstances in each jurisdiction. The European Commission (see below) has also considered how and the extent to which ISAs could be adopted for use in relation to statutory audits in the EU.

Regional organizations of IFAC

Regional organizations of accountancy bodies have been established in many parts of the world, as explained in Chapter 4. Among the most important are the:

- Confederation of Asian and Pacific Accountants (CAPA);
- Fédération des Experts Comptables Européens (FEE);
- Interamerican Accounting Association (IAA);
- Eastern, Central and Southern African Federation of Accountants (ECSAFA).

These organizations are not standard-setters themselves. Nevertheless, they play an important role in making the international audit standards available in other languages (Spanish, for instance) and in the enhancement of the profession in their regions through education, congresses and harmonization. FEE has a particularly important role in representing the views of the European profession on public policy matters to the European Commission.

European Union

Within the European Union, the Council of the European Communities has issued Directives on the preparation, publication and audit of company annual financial reports, namely the Fourth and Seventh Directives, in order to harmonize legislation within the Union. The Eighth Directive sets the qualification and education criteria for auditors. Historically, none of these has contained requirements on the methods of conducting an audit. However, the amendments to the Directive and, in particular, the new Regulation governing the audit of public interest entities introduced a number of specific articles governing independence, quality management, the audit of groups and the content of the audit report and report to the audit committee. The Directive fell short of mandating adoption of the ISAs, but it set the stage for the European Commission to be able to require their adoption as long as certain conditions have been met. See Chapter 13 for more details. Evans and Nobes (1998a and 1998b) examined the limited harmonization brought about by the original version of the Eighth Directive between Germany and the United Kingdom in the areas of the structure of audit firms and independence.

The European Commission published a Communication, 'Reinforcing the statutory audit in the EU', in May 2003, setting out the Commission's strategy on audit matters for the next few years, including the need to modernize the Eighth Directive, strengthen public oversight of the profession and establish appropriate regulatory structures at EU level. A draft revised Eighth Directive was published in March 2004 and, following extensive consultation and review by committees of the European

Parliament, received final approval in April 2006. The revised Directive requires the use of international auditing standards for statutory audits in the EU – once those standards have been subject to an endorsement procedure. Member state authorities can only impose additional requirements in certain defined circumstances. This was also reflected in the Directive and Regulation approved in June 2014.

The European Commission, despite having consulted publicly on the issue in 2009, has yet to determine the mechanism to be used for endorsing the ISAs for use in Europe – it may differ from that used to endorse IFRS accounting standards. Duhovnik (2011) sets out the advantages of EU endorsement, particularly for the emerging economies in Eastern Europe.

US Public Company Accounting Oversight Board (PCAOB)

This chapter is not generally concerned with describing the activities of national standard-setters. However, the US PCAOB, established following the Sarbanes-Oxley Act of 2002 (see Chapter 8), is unusual because of its potential influence on audit standards and practice in other parts of the world. The PCAOB was established to set standards for, and to monitor the quality of, audits of companies listed on the US capital markets. Although its primary focus is domestic US listed companies and their auditors, its remit extends to audits of foreign registrant companies.

The PCAOB issues its own audit standards, which are in addition to the body of US GAAS issued by the AICPA. In particular, it issued Auditing Standard No. 2 (AS2) which dealt with the auditor's responsibilities in relation to internal control (under section 404 of the Sarbanes-Oxley Act) in conjunction with an audit of financial statements. Following significant public debate the PCAOB issued Auditing Standard No. 5 (AS5), which replaced AS2 from 2007. Auditors of foreign private issuers listed on US markets are affected by the PCAOB's standards.

Foreign audit firms (that is, auditors of foreign issuers listed on US markets) are required to register with the PCAOB, which has directly inspected the quality of their work in some countries. The extent to which the PCAOB will rely on the national external audit inspection procedures in some jurisdictions remains to be seen. However, it seems clear that the PCAOB will have a growing influence on the environment for international auditing.

International Forum of Independent Audit Regulators

In September 2006, the major independent audit regulators from 17 jurisdictions formed the International Forum of Independent Audit Regulators (IFIAR). In addition, new independent audit regulators were created in different jurisdictions around the globe, and the membership of IFIAR has increased to bring together independent audit regulators from a total of 50 jurisdictions. IFIAR focuses on the following activities:

- sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms;
- promoting collaboration and consistency in regulatory activity;
- providing a platform for dialogue with other international organizations that have an interest in audit quality.

IFIAR hosts annual plenary meetings, as well as an Inspection Workshop to exchange information and experiences relating to inspections of audit firms. IFIAR has established a number of working groups that address various work streams important to audit regulators and form the core of IFIAR's activities alongside its plenary meetings and workshop.

IFIAR became a member of the Monitoring Group overseeing the IFAC standard-setting bodies in 2011. The Monitoring Group oversees audit and accounting related standard-setting activities of IFAC, monitors the activities of the PIOB, and convenes to discuss issues and share views relating to international audit quality and regulatory and market developments having an impact on auditing.

Other organizations

A number of other international organizations, such as the OECD, UNCTAD and the World Bank, have issued pronouncements on financial reporting issues. However, they are not directly involved in audit standard-setting at the technical level.

Some of these international organizations, as well as IOSCO, the Basel Committee of Bank Regulators and the European Commission, are represented on the Consultative Advisory Group (CAG) that meets to provide input to the IAASB on its standard-setting programme.

The global financial crisis led to the agreement in April 2009 by leaders of the G20 major developed and developing nations to enhance the standing, resources and mandate of the Financial Stability Board (FSB, formerly Financial Stability Forum). The ISAs are one of the 12 key international standards and codes identified by the FSB and hence takes an interest in IAASB's standard-setting activities and governance.

19.4 The international audit process

19.4.1 Introduction

The following description of an international audit process gives a brief overview of what an international audit looks like. It is based on the ISAs issued by IFAC. International firms of accountants have similar processes described in their audit methodologies. Although similar, these processes are not identical because the basic principles and essential procedures will be tailor-made to accommodate the firm's own approach. For instance, one firm might have a tendency towards a more systems-based approach or towards an approach that places more reliance on analytical review or sampling. Before moving to the details of the audit process, one should consider the environment in which audits take place, as shown in Figure 19.1.

The objective of an audit is to enable the auditor to express an audit opinion (reasonable assurance) on whether the financial statements give a true and fair view or fair presentation in accordance with the 'applicable financial reporting framework' (i.e. the set of rules being used, e.g. IFRS). In forming this opinion, the auditor carries out procedures designed to obtain sufficient appropriate evidence as to the reliability of an assertion that is the responsibility of one party for use by another party. The auditor's opinion helps to establish the credibility of the financial statements by providing a reasonable, but not

Figure 19.1 The environment of the audit

absolute, level of assurance that these are free of material misstatements. Absolute assurance is neither attainable nor required by the users of financial statements. Audits cannot provide absolute assurance because of such factors as the need for judgement, the use of testing, the inherent limitations of any internal control system and the fact that much of the audit evidence is persuasive rather than conclusive. Users do not require absolute assurance because, for their decision-making, a 'fair' view of the financial position and the results and trends in it are more relevant than the exact amounts. Preparing financial statements involves the selection of accounting policies, and the making of accounting estimates and judgements, which necessarily cannot be exact.

Auditors can also be engaged to provide other types of assurance services, which are distinguished from audits in IFAC's framework as shown in Figure 19.2. A 'review' is defined as an engagement in which an auditor is asked to carry out procedures that provide a limited level of assurance on financial information, being a lower level of assurance than that provided by an audit. The procedures, consisting primarily of inquiry and analytical review, are performed to provide auditors with a reasonable basis for stating whether anything has come to their attention that causes them to believe that the financial statements do not give a fair presentation or true and fair view in accordance with the applicable financial reporting framework. Auditors are often engaged to perform reviews of interim (e.g. half-yearly or quarterly) financial information. 'Agreed-upon procedures' refers to the situation in which an auditor is engaged to apply the procedures, on which the auditor and client have agreed, to individual items of financial data, a financial statement or set of financial statements. The auditor is only required to present the evidence collected to the user, and the report of factual findings provides no assurance on assertions. The user has to draw his or her own conclusions from the auditor's findings. Examples of this type of service are due diligence reports in the context of merger and acquisition activity and reviews of compliance with contractual arrangements. A 'compilation' involves collecting, classifying and summarizing financial information. In this case, the auditor is engaged in his or her capacity as accounting expert and is not required to perform procedures designed

	Assurance services		Related services	
Nature of service	Audit	Review	Agreed-upon procedures	Compilation
Comparative level of assurance provided by the auditor on assertions	Reasonable, but not absolute, assurance	Limited assurance	No assurance	No assurance
Report provided	Positive assurance on assertion(s)	Negative assurance on assertion(s)	Factual findings of procedures	Identification of information compiled

Figure 19.2 Services by auditors

to obtain evidence regarding underlying assertions and, therefore, the professional accountant does not express a conclusion or opinion carrying any assurance.

19.4.2 Ethics

IFAC's Code of Ethics for Professional Accountants sets standards for conduct and states the fundamental principles that have to be observed. Performing audits in accordance with ISAs requires adherence to relevant ethical requirements, which ordinarily comprise Parts A and B of the Code of Ethics together with national requirements that are more restrictive. A distinguishing mark of a profession is acceptance of its responsibility to the public interest. The public relies on the objectivity and integrity of the accountancy profession for the orderly functioning of commerce. This reliance imposes a public interest responsibility on the profession.

The Code of Ethics recognizes that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement set out above. The Code states the fundamental principles that apply to all professional accountants:

- integrity;
- objectivity;
- professional competence and due care;
- confidentiality;
- professional behaviour.

This list of required characteristics can be expanded upon. 'Integrity' requires the professional accountant to be straightforward and honest. 'Objectivity' requires the professional accountant not to allow bias, conflict of interest or undue influence of others to override professional judgement. The principle of 'professional competence

and due care' is that providing professional services implies a level of competence necessary to perform these services and that the knowledge, skill and experience are applied with reasonable care and diligence. This also requires the auditor to keep his or her knowledge up to date. 'Confidentiality' implies that the auditor does not use or disclose information acquired without proper authority. The duty of confidentiality may be overridden by legal or professional duties (or rights). Confidentiality is one of the strictest rules in auditing firms. Especially when the firm is large, it can hardly avoid serving competing clients. The firms have well-established procedures that prevent engagement teams for one client from acquiring information about another. 'Professional behaviour' means complying with relevant laws and regulations and avoiding any action that discredits the profession – most firms' practice manuals elaborate this requirement to protect the name of the firm.

The section of the Code for accountants in public practice addresses not only independence but also such topics as fees and commissions, incompatible activities, clients' monies, advertising and solicitation and relations with other accountants in public practice. The latter addresses both working relations between auditors and their communication on changes of auditors.

The independence rule in the Code states that independence should be interpreted as independence of mind (the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity and exercise objectivity and professional scepticism) and independence in appearance (the avoidance of facts and circumstances that would cause a reasonable and informed third party to conclude that integrity, objectivity or professional scepticism had been impaired).

Partly in response to recent corporate scandals and a perception of conflict of interest on the part of many of the groups involved (including boards, auditors, analysts, investment banks and regulators), a new version of the Code of Ethics was introduced in 2004 (and revised again in 2010). Significantly, the Code also applies to assurance assignments other than simply audit engagements. The Code follows a conceptual approach to independence. It is designed to assist auditors in (i) identifying threats to independence; (ii) evaluating whether the threats are significant; and (iii) identifying and applying appropriate safeguards to eliminate or reduce the threats to an acceptable level. Safeguards include such measures as the use of second 'review' partners and rotating the engagement partner after a specified number of years. In situations where no safeguards are available to reduce the threat, the only possible action is to eliminate the activities or interest creating the threat, or to refuse to accept or continue the engagement. Further guidance is included in the Code on situations that impair independence, such as financial involvement with the client, appointments to managerial positions in the client (before or after the audit), the provision of non-assurance services to assurance clients (such as consulting or bookkeeping) and personal relations.

In practice, international firms have more detailed regulations, such as listings of publicly held audit clients in which no investments are allowed by all or part of the partners and staff, together with procedural guidance to ensure adherence to the requirements.

Beginning in 2007, the International Ethics Standards Board for Accountants consulted on further potential revisions to the Code of Ethics for professional accountants. This resulted in further refinements to the Code, including the requirements in respect of partner rotation and the provision of non-assurance services, and extension of the

independence requirements to the audits of a wider range of public interest entities. The revised Code was published in 2010 and became effective from the beginning of 2011.

Litt *et al.* (2014) suggest that there may not be any improvement in quality resulting from audit partner rotation. Guénin-Paracini *et al.* (2015) examine the difficulties of achieving independence in practice.

19.4.3 Technical standards

IFAC's Code of Ethics requires that, in performing professional services, auditors should act diligently in accordance with applicable technical and professional standards. These may be the standards promulgated by IFAC (e.g. the pronouncements of its committees such as ISAs), the auditor's professional body or other regulatory bodies and relevant legislation.

The audit methodologies of most of the large international network firms are based on ISAs. However, the basic methodology is supplemented by national requirements, to the extent that these vary or go beyond those in ISAs. Technical standards in firms' manuals are also generally more detailed than the ISAs. For example, an audit firm might set out more detailed requirements on which audit working papers should be completed or which documentation should be kept on the files. Detailed requirements ensure that audits are carried out in a similar manner all over the world and allow international review for quality-control purposes.

19.4.4 Quality control

An international audit firm works all over the world under the same name. Therefore, users expect the same quality internationally. IFAC has issued important pronouncements on audit quality both at the firm level and at the engagement level. ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements specifies the measures to be taken at firm level. For example, in most large network firms, a programme of quality-control reviews of national firms is conducted, normally including participation from other member firms, in order to ascertain adherence to the international firm's standards by its separate national member firms. Ordinarily this is on the basis of a rotation scheme, so that all member firms are reviewed over a period of years. These reviews address national quality-control procedures and could include reviews of files on a test basis. Poor performance would result in remedial action; in the worst cases it could result in excluding a partner from practice and/or excluding a national firm from the international network.

The objective of a quality-control system at firm level is to provide reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory requirements, and that reports issued by the firm are appropriate in the circumstances. ISQC 1 specifies that the system of quality control in the firm is required to include policies and procedures addressing:

- *Leadership responsibilities for quality within the firm*: it is a responsibility of the firm's leadership to promote a culture of quality and to communicate quality-control policies and procedures.

- *Relevant ethical requirements*: compliance with relevant requirements such as IFAC's Code of Ethics should be embedded in the firm's system of quality control.
- *Acceptance and continuance of client relationships and specific engagements*: detailed policies and procedures should be established in this area.
- *Human resources*: the firm should establish procedures to assign sufficient staff with the technical and other competencies necessary to perform its engagements in accordance with professional standards.
- *Engagement performance*: procedures are needed to ensure engagements are performed in accordance with professional standards (including procedures for staff supervision, consultation on contentious matters and resolution of differences of opinion).
- *Engagement quality-control review*: listed company engagements should be subject to review by a second review partner.
- *Monitoring*: firms should have an internal inspection programme for ensuring that the work of individual offices and partners is reviewed on a regular basis.

In addition to the firm-wide requirements in ISQC 1, engagement-level requirements are specified in the audit standard ISA 220 Quality Control for an Audit of Financial Statements. These requirements mirror, at the level of the individual audit, those of ISQC 1 (e.g. requiring the engagement partner to be satisfied that potential threats to independence have been assessed, appropriate engagement acceptance procedures have been followed, and the work of the engagement team has been adequately supervised and reviewed).

Given the litigious environment of the accountancy profession in many countries, most firms have further strengthened their quality-control procedures and incorporated schemes of risk management, which include stricter rules on the acceptance and retention of clients and the abandonment of some services and clients that are judged to carry unacceptably high risks. Regulators and other interested parties have expressed interest in knowing more about the quality-control processes operated by the firms. For example, the EU Eighth Directive includes a provision for firms to disclose publicly more details of their processes around audit quality. Recently, a number of the large firms have issued 'Transparency' reports at a national (and in some cases global) level, explaining some of the quality-control policies and procedures adopted.

19.4.5 The audit process

The four main stages of an audit process are:

1. acceptance and defining the terms of engagement;
2. planning, including assessment of audit risk and materiality;
3. gathering audit evidence;
4. reporting.

International auditing firms may use different names for the stages, but in principle all audit processes come down to these steps, which are discussed below under these headings.

Acceptance and defining the terms of engagement

As part of their quality control, firms will apply specific procedures before accepting an engagement. These normally require involvement and agreement by more than one partner and are implemented to safeguard the audit firm's independence and to ensure its ability to serve the client properly. A major consideration is the integrity of the client's management, directors and principal owners.

It is normal practice to set out the terms of engagement in an engagement letter, drafted by the auditor and signed for agreement by the client. The engagement letter is designed to document and confirm the client's understanding of the auditor's appointment, the scope of the auditor's work, the extent of the auditor's responsibilities and the form of any reports. ISA 210 describes the principal contents of an engagement letter, and its appendix contains an example of a letter. The ISA also discusses the limited circumstances in which an auditor may subsequently accept a change in the terms of an engagement.

Planning and risk assessment

Planning is the process of developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit work. The planning should result in an efficient and effective audit, carried out in a timely manner.

The general strategy or overall audit plan describes the expected scope and conduct of the audit. It is not uncommon for the overall plan to be discussed and agreed with the client, for instance with an audit committee. However, the auditor has to remain in command, deciding what work to perform as the basis on which an opinion can be issued.

At the planning stage, consideration is given to the following:

- knowledge of the business (general economic factors and industry conditions affecting the client's business; important characteristics of the client, its business, financial performance and reporting requirements; the level of competence of management);
- accounting and internal control systems (accounting policies adopted; the effect of new accounting or auditing pronouncements; the auditor's cumulative knowledge of the accounting and internal control systems);
- risk and materiality (see below);
- the nature, timing and extent of procedures (including possible changes in emphasis between audit areas; the effect of IT on the audit; the consideration of the work of internal auditors);
- coordination, direction, supervision and review (staffing requirements; involvement of experts; the coordination and instruction of the other auditors of components of the group).

Knowledge of the business is critical to all stages of the audit, as regulation of business is increasingly on industry sector lines. Accounting and reporting requirements are developed for specific industries, such as banking and insurance. Even more mainstream businesses, such as energy and telecommunications, are today heavily regulated, and a modern audit often requires a significant degree of specialist knowledge and expertise.

For a multinational company, with locations in many countries, the planning process and in particular the timely instruction of and communication with auditors in these countries are very important. International audit firms can handle this complex area more easily than local firms can as they have the procedures, understanding of each other's responsibilities and the networks in place.

The planning process results in an overall audit plan, sufficiently detailed to serve as a basis for the preparation of the detailed audit programme. It could be viewed as breaking down the financial statements of the company and its underlying business processes and related information systems into areas of attention for the audit. A preliminary choice is made as to the likelihood of the mix of audit procedures, such as substantive testing for accounting estimates or non-routine transactions, relying on internal control or IT systems for routine transactions (generally the day-to-day transactions such as sales, purchases and payroll) and the need to use specialists in the audit team. On international audits, it is not uncommon to rotate the emphasis – for example, on the less important subsidiaries, between full audits in one year and limited reviews in subsequent years.

Audit risk and materiality

The concepts of materiality and audit risk, their interrelationship and the application of these concepts are the most significant for the auditor in order to perform an audit. They are used when planning and conducting an audit and when evaluating the results of the procedures.

Information is material if its omission or misstatement could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. The assessment of materiality is a matter of the auditor's professional judgement and is considered at the overall financial statement level. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatement of lesser amounts for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor is expected to determine the materiality level or levels to be applied to those particular transactions, account balances or disclosures. Audit risk is defined as the risk that an auditor may give an inappropriate opinion on financial information that is materially misstated.

Audit risk and materiality are interrelated, as can be seen from the definition of audit risk. The higher the materiality threshold, the lower the risk. The auditors cannot raise the materiality level as they desire, as it rests on judgement of what the users of financial statements would view as relevant information. Disclosure guidelines in reporting frameworks such as IFRS may help in forming this judgement. An audit in accordance with GAAS requires the auditor to keep audit risk at an acceptably low level.

Audit risk has three components: inherent risk (the risk that there is an error), control risk (the risk that internal control procedures do not discover the error) and detection risk (the risk that the auditor fails to detect an error). Inherent risk and control risk are often correlated, in the sense that if management feels that the inherent risk is high, it will normally implement stronger internal controls.

The auditor seeks evidence that the accounting system is adequate and that all the accounting information which should be recorded has been recorded. Internal controls normally contribute to such assurance, although there are inherent limitations in any system of internal control. The auditor's work therefore includes obtaining an understanding of the entity's process for identifying business risks relevant to financial reporting, and of the information system and related processes (including control activities) relevant to financial reporting. The auditor reports to management any material weaknesses in the design or implementation of the internal control systems that have come to the auditor's attention. The auditor's assessment of control risk is then used to determine the nature, timing and extent of audit procedures (which may include substantive testing) so as to restrict detection risk to an acceptably low level. The relationship between the assessments of inherent and control risks to substantive procedures is described in the auditing standards by indicating that some substantive procedures should always be performed and reassessed as the components of audit risk change.

Gathering audit evidence

The planning stage of the audit, including the assessment of the components of audit risk, results in a detailed audit programme. This is the set of instructions for the audit team as to the procedures that should be performed to conduct the audit. Performing these procedures – both the tests of controls and substantive procedures – can be seen as a process of gathering audit evidence. Tests of controls are performed to obtain audit evidence about the design and operation of the accounting and internal control systems. Substantive tests or procedures are performed to obtain audit evidence to detect material misstatements in the financial statements, and they are generally of two types: (a) analytical procedures; or (b) tests of details of transactions and balances, which may involve the use of sampling.

Audit evidence is information obtained by the auditor in arriving at the conclusions upon which an opinion on the financial information is based. Ordinarily, the auditor will have to rely on audit evidence that is persuasive rather than conclusive. The auditor will therefore often seek evidence from different sources of a different nature to support the same assertion. The procedures for obtaining audit evidence are:

- inspection (of records, documents or assets);
- observation (of an internal control procedure);
- inquiry and confirmation (asking and corroborating);
- computation (of a provision or checking calculations);
- analytical procedures.

The last in the list, analytical procedures, consists of the analysis of significant ratios and trends, including the resulting investigation of relationships and fluctuations that are inconsistent with other relevant information or deviate from predicted amounts. Relationships can be very stable (e.g. between cost of sales and sales in cases where there is a fixed margin) and may therefore be powerful tools for the auditor.

Accounting estimates and fair values. An 'accounting estimate' is defined as an approximation of the amount of an item in the absence of a precise means of measurement. Management is responsible for making accounting estimates based upon

its judgement of the uncertain outcome of events that have occurred or are likely to occur. As has been experienced in the recent financial crisis, this can be a difficult and highly sensitive area. The auditor is responsible for evaluating the reasonableness of estimates, but due to the approximation inherent in accounting estimates, such an evaluation cannot be made as accurately as in other areas of the audit. The increasing use of fair values in financial accounting (e.g. under the IFRS framework) means that auditors are having to understand and assess the processes used by management to determine fair value measurements.

Written representations. Auditing standards indicate that representations by management cannot be a substitute for other audit evidence that could reasonably be expected to be available. However, the auditor should also obtain written representations from management that it acknowledges its responsibility for the financial statements, and on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Examples of items on which specific representation might be sought include the completeness of related party information, contingent liabilities and guarantees, subsequent events and the existence of unassessed claims.

Internal audit. The internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within an entity. An objective of the internal auditor is to determine whether internal controls are well designed and properly implemented. Much of the work of the internal audit department may be useful to the independent auditor for the purpose of examination of the financial information.

Reporting

The reporting stage of the audit comprises two parts: first, reviewing and evaluating the conclusions drawn from the audit evidence obtained in order to ensure that the audit risk is at an acceptably low level; and, secondly, the review of the financial statements in order to ensure that these comply with the relevant financial reporting framework.

The Auditor's Report on the financial statements is often the only publicly available aspect of the auditor's work. It is, however, not necessarily the only report issued by the auditor. Depending on legal circumstances and/or the terms of the individual engagements and indeed as required under ISA 260, auditors report their findings in more detail to management and those responsible for the governance of the entity, such as an audit committee or any supervisory directors.

Increasingly, audit committees – composed wholly or mainly of independent non-executive board directors – are becoming the primary focus for the company's relationship with the external auditors. The committee's responsibility is to oversee on behalf of the board the integrity of the financial reporting controls and procedures implemented by management, and of the published financial information itself. A study by PricewaterhouseCoopers (2003) found that 16 of the world's 41 major economies had mandatory requirements for audit committees. A further 14 countries had voluntary arrangements.

Recognizing this shift in the relationship between the external auditor and the client, the IAASB issued an audit standard ISA 260 Communication with Those Charged

with Governance. The standard lists those matters that the auditor would ordinarily communicate to the audit committee, including:

- the responsibilities of the auditor in relation to the financial statement audit;
- planned scope and timing of the audit;
- matters relating to the independence of the auditor;
- significant findings from the audit including;
- views about significant qualitative aspects of the accounting policies;
- significant difficulties, if any, encountered during the audit;
- significant matters arising during the audit that were discussed with management;
- written representations requested by the auditor;
- other matters that in the auditor's judgement are significant to the oversight of the financial reporting process.

A separate standard, ISA 265, deals with how the auditor communicates to the audit committee and to management regarding deficiencies in internal control noted during the audit.

In an international audit of a diversified group, the auditor can also gather information on, for example, the financial controls in the various subsidiaries that is useful to the senior management of the group. Such information, which is normally called an Inter-office Memorandum, is, after being discussed with local management, reported to the parent's auditor, who will compile an overall report to top management. Thus, in addition to the formal auditor's report, in many cases a tailor-made report will be issued to management containing information relevant for financial analysis and for control of the business.

ISAs set requirements and provide guidance on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of an entity. Until recently, the content of the standard auditor's report focused on the auditor's binary opinion as to whether or not the financial statements were free of material misstatement. The 'unqualified' (or 'clean') opinion is the most familiar one and should be expressed when the auditor concludes that the financial statements present fairly or give a true and fair view in accordance with the 'applicable financial reporting framework' (i.e. the requirements, not the conceptual framework). An unqualified opinion also indicates implicitly that any material changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. In circumstances where the auditor is not satisfied with the audit evidence or with the compliance of the financial statements with the identified framework, a qualified or adverse opinion or a denial of opinion (often referred to as a disclaimer) will be issued.

Particularly following the financial crisis, investors and other users of financial statements called for the auditor's report to be more informative – in particular for auditors to provide more relevant information based on the audit that was performed. In response, the IAASB has issued new and revised auditor reporting standards that enhance the communicative value of the auditor's report in the public interest. The main innovation is the introduction of a new section in the auditor's report of listed entities (or voluntarily for other than listed entities) that describe 'key audit matters',

being those matters that, in the auditor's judgement, were of most significance in the audit of the current period financial statements.

Other elements of the new reporting model include:

- Presenting the opinion section first, followed by the basis for opinion (unless law or regulation prescribe a different format).
- Enhanced reporting on going concern, including:
  - Enhanced descriptions of the respective responsibilities of management and the auditor for going concern.
- A separate section when a material uncertainty exists and is adequately disclosed, under the heading, 'Material Uncertainty Related to Going Concern'. An affirmative statements about the auditor's independence and fulfillment of relevant ethical responsibilities, with disclosure of the jurisdictions or origin of those requirements or reference to the IESBA Code of Ethics.
- Enhanced description of the auditor's responsibilities and key features of the audit.

The new report comes into effect of the audits of financial statements for periods ending on or after December 15, 2016. Readers can examine audit reports prepared under ISAs by looking at the annual reports of listed companies, such as US companies or UK companies.

Expectations and information gaps

In response to some concerns voiced by stakeholders about the usefulness of the current auditor's report, the IAASB in 2011 issued a consultation paper called *Enhancing the Value of Auditor Reporting: Exploring Options for Change*. The paper describes issues in current financial reporting, including an 'expectations gap' between what users think the auditors deliver, and what they currently deliver. There is also a newly perceived 'information gap', whereby some stakeholders recognize that there is a richer set of information about the entity than that which they are currently receiving. Such a gap will always exist in a dynamic society because stakeholders may change (in the past, only shareholders were viewed as the legitimate stakeholders) and may have information requirements that are not (or not yet) addressed by management (such as information on control systems or environmental behaviour) and hence not yet part of the financial statements and the audit.

The extent of the auditors' responsibilities in specific areas is often misunderstood by management and by financial statement users. This contributes to the above 'expectations gap'. This section sets out some of the relevant considerations in relation to fraud and error, compliance with the law, subsequent events and going concern.

The responsibility for the prevention of fraud and error rests with management. The auditor should plan the audit so that there is a reasonable expectation of detecting material misstatements resulting from fraud and error. The auditor should carry out additional procedures when they have an indication that fraud or error may exist. The auditor has specific reporting duties to the directors (and in some countries to regulators) and may ultimately have to consider withdrawing from the engagement if management chooses to allow fraud to continue or, more seriously, if management actively colludes in the fraud.

When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with laws and regulations may materially affect the financial statements. The auditor does not have the skills to, and is not required to, consider all laws and regulations, but the auditor's knowledge of the business of the entity and inquiries with management on how compliance is controlled by the entity will help in planning the audit. The auditor has no responsibility to detect non-compliance but should act if the auditor discovers indications that it may exist, and has specific reporting duties to those charged with governance (and may in some countries have additional responsibilities to report to regulatory and enforcement authorities). The auditor may ultimately have to consider withdrawing from the engagement if management chooses to continue the non-compliance.

The date of the auditor's report (which cannot be before the date on which those with the recognized management authority have asserted that they have taken responsibility for the complete financial statements) sets the boundary for the auditor's responsibility in relation to subsequent events, such as significant events occurring after the balance sheet date and facts emerging after the financial statements have been issued. The auditor generally performs specific steps to identify subsequent events until the date of the auditor's report.

The recent global financial crisis and economic downturn have increased attention on the respective responsibilities of management and auditors in relation to going concern. In discharging their responsibilities in relation to going concern, the auditors would consider the process undertaken by management to assess the appropriateness of the 'going concern' assumption as a basis for the preparation of financial statements. Management, and the auditors, would normally consider the 'foreseeable future' – usually taken to be a period of not less than one year after the balance sheet date. The notion is that an entity's continuance as a going concern is assumed in the absence of information to the contrary. If there is significant doubt, the auditor must perform procedures to confirm or dispel that doubt and should particularly ensure that the entity complies with the requirements of the financial reporting framework.

The recent adverse economic conditions have led the authorities and regulators in a number of countries to issue or refresh guidance for directors on going concern (for example by the Financial Reporting Council in the United Kingdom) while audit standard-setters and professional bodies have issued additional guidance for auditors (such as the IAASB's Practice Alert mentioned earlier in this chapter).

SUMMARY

- Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to interested users.

- International auditing can be seen as referring to the harmonization of auditing standards and rules across countries as well as referring to the practice of auditing the financial information prepared by multinational corporations, based on one or more sets of auditing rules.
- The process of internationalization of auditing was triggered by the development of multinational corporations, which need an efficient and effective audit supporting their information and control systems. Until the middle of the twentieth century, most audit firms operated largely within national borders. However, the need to serve ever-growing clients has caused a movement of mergers and strategic alliances between auditing firms to be able to serve their largest clients worldwide. Auditing practice changed from an activity dominated by local traditions and roles to a process of investigation and reporting which takes place on an international scale.
- The globalization of capital markets has shown the need for a clearly defined role for auditing as a means to add credibility to the financial information provided by companies seeking finance in international capital markets. In order to define this role clearly, ISAs have been developed by IFAC. Its standards are increasingly recognized by the business community, users and regulators as setting the benchmarks for audits.

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Useful websites

Deloitte	www.deloitte.com
Ernst & Young	www.ey.com
IFAC Forum of Firms	www.ifac.org/Forum_of_Firms
International Auditing and Assurance Standards Board	www.ifac.org/IAASB
KPMG	www.kpmg.com
PricewaterhouseCoopers	www.pwc.com
Public Interest Oversight Board	www.ipiob.org

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

19.1* Why is it necessary to have international auditing standards?

19.2* Would it be better if international auditing standards were set by the United Nations rather than under the existing system?

19.3 Why do auditing standards differ internationally?

19.4 In what senses can certain aspects of auditing be described as 'international'?

19.5 Is it easier to reach agreement on international standards on auditing (ISAs) than on international accounting standards? If so, why?

19.6 Discuss the effect that the growth of multinational enterprises has had on audit firms.

20 Enforcement of financial reporting standards

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OBJECTIVES

After reading this chapter, you should be able to:

- explain the various ways in which the application of financial reporting standards by listed companies can be monitored and enforced; and
- compare and contrast the monitoring and enforcement bodies and processes used in the US; the member states of the EU (with particular reference to the UK, France and Germany); and Australia, China and Japan.

20.1 Introduction

Chapter 5 discussed, in general terms, financial reporting by listed companies around the world. Chapters 6–9 examined the accounting rules under the two main systems for listed companies: IFRS and US GAAP. Chapter 11 studied financial reporting in China and Japan, including reporting by listed companies. Chapters 16–18 looked at accounting issues particularly associated with large listed groups. Chapter 19 explored the first stage of the monitoring of compliance by companies with financial reporting rules: external audit. Although the auditors are ‘external’, they work

for the company, in the wide sense that includes its owners; and they have access to internal information. This last chapter discusses how, and to what extent, the financial reporting rules are monitored from outside the company and then how they are enforced. Modes of enforcement vary from country to country much more than the rules themselves do. Enforcement remains largely national rather than international.

Good financial reporting relies on:

> a cascade of different elements including (1) clear accounting standards (2) timely interpretations and implementation guidance (3) statutory audit (4) monitoring by supervisors and (5) effective sanctions. Each of these must work efficiently: the system will be as strong as its weakest part in delivering strong investor and creditor protection.
>
> (Commission of the European Communities, 2000, paragraph 26)

This chapter discusses the last two of these elements. Leuz (2010) reviews the arguments in favour of having enforcement agencies. These include that there might be a socially optimal level of disclosure, and that it is efficient to avoid individual firm-based negotiations about how to do accounting. Enforcement has been said to be critical to the stability of the financial system (European Commission, 2010; Malsch and Gendron, 2011; Arnold, 2012). Many researchers have concluded that the benefits of adopting IFRS in a country rest greatly on there being strong enforcement in the country (e.g. Daske *et al.,* 2008; Christensen *et al.,* 2013).

'Enforcement' is a difficult concept to quantify and measure. Hope (2003) compiled a country enforcement index comprising five elements: audit spending, judicial efficiency, rule of law, insider trading laws and shareholder protection. He calculated the index for 21 countries. The highest value was for the US, followed by the UK, Canada, Norway, Sweden and Japan. The lowest value was obtained by Italy, followed by Spain, South Africa, Portugal and Germany. Brown *et al.* (2014) note that researchers have used a range of legal system proxies to capture country differences in enforcement, but they suggest that the proxies seldom focus explicitly on factors that directly affect compliance. To address this, Brown *et al.* calculate measures of the quality of the audit working environment and the degree of accounting enforcement activity by independent bodies. They do this for 51 countries for each of the years 2002, 2005 and 2008, although they do not provide a ranked list such as that in Hope (2003). Preliminary tests suggest their indices have additional explanatory power (compared to general legal proxies) for country-level measures of economic and market activity, financial transparency and earnings management. Preiato *et al.* (2015) apply the indices to analysts' forecasts, using 2003–2009 data on firms from 39 countries. They show that high scores on the indices are associated with better forecasts.

In this chapter we compare and contrast monitoring and enforcement in seven countries: the US; three member states of the European Union (the UK, France and Germany); and three West Pacific-rim countries (Australia, China and Japan). These countries have been chosen because they have a considerable number of listed companies and a high market capitalization (see Table 1.5).

The emphasis in the chapter, as with the enforcement effort in these countries, is on publicly traded (listed) companies. Enforcement for other companies still tends to be limited to checking that annual reports have been filed rather than checking their contents. In the countries discussed in this chapter, listed companies are required to

apply, at least for their consolidated financial statements, US GAAP, IFRS or standards converging with IFRS. All of these comprise reasonably clear standards accompanied by implementation guidance.

Section 20.2 looks at possible modes and models of enforcement. In Sections 20.3 to 20.5, we consider how enforcement operates in our chosen countries.

20.2 Modes and models of enforcement

In this section, we distinguish rule-making from rule-enforcing (which includes rule-monitoring); analyze the different sorts of enforcement and oversight bodies; note the role of auditors in the enforcement process; discuss the procedural choices of enforcement and oversight bodies; and consider the administrative and other actions available to such bodies.

Rule-making is conceptually different from rule-enforcing. The two functions may be separated institutionally but they may be combined (Brown and Tarca, 2005a). At one extreme, there are bodies which confine themselves to making rules, leaving other bodies to enforce them. An obvious example is the IASB which, as a private-sector body, must leave enforcement to others. At the other extreme, some bodies act only as enforcers, such as the *Autorité des Marchés Financiers* (AMF) in France. There are also bodies, however, which act both as rule-makers and rule-enforcers. The best known example is the Securities and Exchange Commission (SEC) in the United States. Nevertheless, as discussed in Chapter 8, most of the rule-making in the USA is performed in the private sector by the Financial Accounting Standards Board (FASB) with the backing of the SEC.

Another hybrid example is the UK's Financial Reporting Council (FRC). This is a private-sector body, but it is recognized in law as the setter of accounting standards for non-IFRS financial reporting. Further, the FRC's Financial Reporting Review Panel is the key monitoring body in the UK. However, it has to rely on the law courts for enforcement, as will be explained.

Enforcement of financial reporting rules can be carried out by several different sorts of bodies. These include:

- stock exchanges;
- regulators of stock exchanges;
- government departments;
- private-sector bodies.

Readers should note the important distinction between stock exchanges and regulators of exchanges. The exchanges themselves are generally profit-making companies. The regulators are agencies of the state whose job is to protect the investing public.

In the US, Australia, China and Japan, enforcement is carried out by a stock exchange regulator. According to FEE (2001), in Europe in 2001 enforcement was carried out by stock exchanges in Norway, Sweden and Switzerland; by stock exchange regulators in Belgium, France, Italy, Portugal and Spain; by a private-sector review panel in the UK; and by government departments in Denmark and the Czech

Republic. There were no enforcement bodies in other European countries at that date. However, since then, with the encouragement of the Committee of European Securities Regulators (CESR which has been replaced by ESMA, see Section 20.4.1) and with the revision of the Eighth Directive, enforcement bodies have been established in Germany (see Section 20.4.4 below), the Netherlands and other member states.

There is no ideal model of an enforcement body to fit all countries. The kind of body chosen, and what powers it is given, depend on the overall regulatory system of the country concerned. This reflects the country's culture or, more narrowly, its political, legal and financial environments, all of which may change over time. Two of the most highly regarded bodies are the SEC in the US and the Financial Reporting Review Panel (FRRP) in the UK, which is part of the FRC. They have served as models to be followed in adapted form in other countries. The SEC model has been followed in Australia, China, Japan and France. A review panel has been set up in Germany. One should beware, however, of assuming that similarity of name implies similarity of function. Brown and Tarca (2007), after a comparison of the performance of the UK and Australian bodies, were unable to conclude whether one model is more effective than the other.

Davies and Green (2008) criticized the world's regulatory regimes as being cumbersome and complex. Caramanis *et al.* (2015) suggest that transplanting Anglo-American mechanisms of enforcement into other legal and cultural environments might not work well. They use the example of Greece.

For many countries, until recently the only monitoring mechanism was an annual audit, and auditors were not subject to much statutory control (Baker *et al.*, 2001). Although audit is a necessary component of the monitoring and enforcement process (see Chapter 19), it is unlikely to be sufficient because auditors cannot always be relied upon to be independent. Auditors (often appointed *de facto*, if not *de jure*, by directors to whom they may provide non-audit services) are perceived to have difficulty in maintaining their independence. Accounting scandals have persuaded legislators in many countries that audit needs supervision. Auditors can benefit from the backing of an enforcement body since otherwise their main means of encouraging compliance with standards is to threaten to qualify their audit opinions.

Until recently, many professional auditing bodies were self-regulating, at least in Anglo-Saxon countries, although this has largely been replaced by the setting up of oversight bodies for audit. An oversight (or supervisory) body in this context is a body independent of the audit profession which regulates the work of the auditor. The audit oversight body may or may not be separate from the body which enforces good financial reporting. Examples of separate bodies are the *Compagnie Nationale des Commissaires aux Comptes* in France and the *Wirtschaftsprüferkammer* in Germany, and the Public Company Accounting Oversight Board (PCAOB) in the US, although all the European bodies are supervised by government ministries and the US body by the SEC. In the UK, the relevant body is the Conduct Committee, which is part of the FRC. In France and Australia the functions of the enforcement bodies (the AMF; and the Australian Securities and Investments Commission, ASIC) include oversight. In China, the audit professional body is controlled by the Ministry of Finance.

The evidence summarized in later sections of this chapter suggests that auditors and enforcement bodies benefit from each other's activities. Enforcement bodies cannot check accounting records in detail and perforce rely on the work of external auditors in this respect. The existence of enforcement bodies strengthens the ability

of the auditor to insist on compliance with financial reporting standards. In the US, auditors are appointed by directors, but both are aware that compliance with GAAP will be strictly enforced by the SEC. In the UK, directors and auditors are reluctant to risk being summoned to appear before the FRRP. In Germany, by contrast, the lack of an enforcement body until 2005 meant that auditors accepted degrees of non-compliance from companies claiming to apply international standards (see Section 20.4.4). This was also a problem in the UK before the FRC was set up in 1990.

Suggestions for improving the global consistency and enforcement aspects of auditing have been made by Humphrey *et al*. (2009) and by Malsch and Gendron (2011).

Enforcement bodies need both to monitor compliance and to take appropriate actions in case of non-compliance. How the monitoring is done and how effective the actions are depends on the powers granted by legislation and on available resources, both financial and human. None of the bodies has the resources to monitor every year all the financial statements of all companies subject to accounting regulation. Even the best-resourced body, the SEC in the USA, monitors only publicly traded corporations (far less than one per cent of all US corporations) and does so on a selective basis. Less well-resourced bodies have to decide whether to monitor proactively as well as reacting to complaints against companies and, if so, whether to do so using a risk-based strategy, by rotation or on a sample basis, or some combination thereof. They also need to decide whether to issue guidance statements and/or to provide advance clearance for particular accounting practices (sometimes referred to as pre-clearance); what action to take in the event of non-compliance (e.g. levying fines, taking a company to court, de-listing); and what use to make of publicity in the financial press and elsewhere.

Summing up, those responsible for setting up and operating enforcement bodies are faced with a number of choices:

- which companies to monitor;
- which company documents to monitor and when;
- whether to monitor proactively as well as reactively;
- to what extent to rely upon the opinions of company auditors;
- whether to issue guidance statements;
- whether to provide advance clearance;
- whether to take administrative or legal action in the event of non-compliance;
- what use to make of publicity.

Different enforcement bodies have come to different conclusions and some have changed their choices over time. Table 20.1 summarizes the position in 2015 for the SEC in the US, the FRRP in the UK, the AMF in France, the BaFin and FREP in Germany (see Section 20.4.4 for full names), and the ASIC in Australia. More details and explanations are given in the country sections that follow. We also explain why within the EU there is not one but several national enforcement bodies. China and Japan were not covered by the paper on which we base Table 20.1 but the relevant bodies, modelled on the SEC, are mentioned in Section 20.5.

It is not easy to measure the success of an enforcement body. For example, the SEC undoubtedly works hard to ensure that most publicly traded corporations follow the

Table 20.1 Comparison of five enforcement bodies

	US	UK	France	Germany	Australia
	SEC	**FRRP**	**AMF**	**BaFin/FREP**	**ASIC**
Type of body	Stock exchange regulator	Private sector	Stock exchange regulator	Govt body/ private sector	Stock exchange regulator
Date established	1934	1991	1967	2004	1998
Procedures					
Reactive investigation	Yes	Yes	Yes	Yes	Yes
Proactive surveillance	Yes	Yes	Yes	Yes	Yes
Advance clearance	Yes	No	Yes	No	No
Powers					
Publicity	Yes	Yes	Yes	Yes	Yes
Fines	Yes	No	Yes	Yes	No
Court referral	Yes	Yes	Yes	Yes	Yes
De-listing	Yes	No	No	No	No

Source: Adapted and up-dated from Brown, P. and Tarca, A. (2005a) 'A commentary on issues relating to the enforcement of international financial reporting standards in the EU', *European Accounting Review*, Vol. 14(1) pp. 181–212.

letter of US GAAP, but it was unable to prevent the sophisticated creative accounting of Enron (Benston and Hartgraves, 2002) or even the simple (but equally devastating) accounting misstatements perpetrated at WorldCom of 2002, or the scheme of Bernard Madoff of 2008.

More generally, it is difficult to quantify the costs and benefits of regulation and regulatory bodies and to determine who pays and who benefits (see, e.g., Gwilliam *et al.*, 2005). The direct costs borne by taxpayers are higher for a body such as the SEC than for private-sector bodies such as the FRRP. There are social as well as private costs and benefits, so the setting up of enforcement and oversight bodies concerns stakeholders of all kinds, not just shareholders, directors and auditors. For example, corporate collapses connected with accounting scandals have deprived many people, not all of them employees of the collapsed companies, of their jobs and pensions. Externalities such as these have been an additional factor in leading governments to concern themselves with compliance with financial reporting standards.

The regulators were very active in providing guidance on financial reporting in the unusual market conditions prevailing in 2008 and 2009 (e.g. AMF, 2008; SEC, 2008).

20.3 United States

Financial reporting in the United States is discussed at length in Chapter 8. This section concentrates on those aspects that concern the monitoring and enforcement of financial reporting standards.

American accountants are more apt than European (including UK) or Asian accountants to assume that, once a standard is passed, it will be complied with. This is a perhaps unconscious tribute to the power of the SEC, an independent federal regulatory agency established in 1934 by Congressional legislation. Since inception, the SEC 'has applied a heavy hand to enforcement', and US accountants are unlikely 'to recall a time when financial reporting was not tightly prescribed, and the prescriptions not strictly enforced' (Zeff, 1995, pages 61, 64). Registration statements of corporations coming to the market for the first time (i.e. prospectuses) are reviewed in detail. Registration statements and periodic reports of other companies are reviewed selectively. Each company is reviewed on a three-year cycle. Discussions between the SEC and registrants are entirely confidential. The SEC's ability to levy fines and de-register companies means that most disputes are settled without any formal action. The SEC does not need to use publicity in the financial press to the same extent as, say, the FRRP in the UK as a means of 'naming and shaming'.

Strict enforcement of compliance by the SEC means that lobbying of the standard-setter (currently the FASB) is more intense in the US than in countries where monitoring and enforcement is more relaxed (see Chapter 10). The SEC has been criticized for hampering accounting innovation, which can be positive as well as negative (Solomons, 1986, pages 194–8).

Non-US companies with a listing on a US stock exchange are required to file financial statements complying with US GAAP or with IFRS as issued by the IASB, or that have a reconciliation to US GAAP. When foreign registrants file IFRS statements with the SEC, it seeks to enforce compliance with IFRS as rigorously as it does with US GAAP.

The reputation of auditors in the US was severely dented by the Enron and other scandals (Zeff, 2003). The Sarbanes-Oxley Act prohibits the provision of some non-audit services to audit clients, requires the rotation of leading and review audit partners every five years, and requires auditors to report to an audit committee not to management. As explained in Chapters 8 and 19, auditors are now supervised by the PCAOB, which registers auditors and has the right to conduct inspections and investigations, take disciplinary action and impose sanctions.

As noted in Table 20.1, the SEC engages in advance clearance of accounting treatments in cases where a registrant is uncertain whether a proposed treatment would be acceptable. It also issues 'Staff Accounting Bulletins' in cases where it believes that a misunderstanding of GAAP is widespread.

20.4 European Union

20.4.1 Introduction

Enforcement of financial reporting standards within the EU used to be very different from that in the US. In recent years, however, it has been influenced by the Sarbanes-Oxley Act (Haller *et al.*, 2006). Little systematic research was done into compliance rates by EU companies with domestic GAAP prior to 2005 but, with the possible exception of the UK and France, compliance was not high. Even in France,

those companies applying US GAAP or IAS tended to comply on a pick-and-choose basis (Ding *et al*., 2003). Gebhardt and Heilmann (2004) find that not only did many German companies fail to comply fully with the accounting standard on cash flow statements (whether the German standard GAS 2, IAS 7 or SFAS 95), but no audit opinions contained a qualification in respect of the non-compliance. However, Glaum and Street (2003) show that German companies that were listed on both that country's New Market and a US exchange showed higher rates of compliance in their domestic reporting.

Street *et al*. (1999), Street and Bryant (2000) and Street and Gray (2001) report a lack of compliance in a wide range of countries both within and outside the EU. Compliance by companies domiciled in EU countries such as France and Germany was worse than that by companies domiciled in countries outside the EU (notably Switzerland and China). Compliance with IAS was particularly weak in respect of disclosures relating to pensions, leasing, financial instruments and earnings per share.

Schipper (2005), an American academic who was a member of the FASB, predicted increasing demand for a pan-European enforcement body, but acknowledged the considerable difficulties, political and otherwise, of setting one up. The replacement of national enforcers by a pan-European enforcer is highly unlikely in the short term. However, under the aegis of ESMA, which replaced CESR in 2011, the national enforcers meet periodically in European Enforcers Co-ordination Sessions (EECS) to exchange views and discuss experiences. These meetings also take place bilaterally. Berger (2010) examines the operations of CESR and EECS in some detail.

ESMA (and CESR before it) publishes extracts from its database of enforcement decisions, but without revealing which national enforcer took which decision. For example, an extract of the enforcement decisions of national regulators published in 2008 (CESR, 2008) reports on 15 decisions concerning IFRS reporting. In nearly all cases, the answers seem not only correct but obviously correct. That is, the regulators are needed in order to force companies to adopt what are clearly the right answers, but answers that companies would prefer to avoid. A report on enforcement cases, published by ESMA in 2015 is accessible online (http://www.esma.europa.eu/system/files/2015-659_activity_report_on_accounting_enforcers_in_europe_in_2014.pdf).

Information is also shared between EU and non-EU enforcers under the aegis of the International Organization of Securities Commissions (IOSCO). Berger (2010) reports that, by late 2009, the EECS had a database of 232 cases that had been discussed by national enforcers. He also discusses ways in which enforcement can vary internationally. Such variation opens up the danger of 'regulatory arbitrage' (i.e. companies choosing to list on exchanges in countries perceived to have the weakest enforcement regime) (Brown and Tarca, 2005b).

Most listed companies in major EU countries are audited by the Big-4 international firms. The technical resources of the 'international desks' (i.e. centres of IFRS expertise) of these firms may play an important part in improving compliance. Oversight of auditors was one of the concerns when the Eighth Directive was being drafted, but its watered-down form of 1984 confirmed rather than changed existing practices in member states. Recent changes have been driven by accounting scandals rather than proactively by the EU Commission. A revised Eighth Directive was approved in 2006 (see also Chapter 19). The Directive requires all member states to set up a national auditors' oversight body but does not envisage

an EU-wide body. A European Group of Auditors' Oversight Bodies (EGAOB) was established in 2005 to encourage cross-border cooperation between the national regulators.

The position in the UK, France and Germany, the EU's three largest economies, is discussed in the next three sections.

20.4.2 United Kingdom

The UK system of setting, monitoring and enforcing accounting standards has changed several times in the last few decades. Before 1990 standard-setting was in the hands of the accountancy profession and had no legal backing. The position of standards was strengthened as a result of the Dearing Report (1988) and the Companies Act 1989 (now replaced by the Companies Act 2006). The Act requires directors of plcs and other large companies to disclose in their annual reports any departures from accounting standards. As discussed in Chapter 14, the Accounting Standards Committee (ASC) was superseded in 1990 by an Accounting Standards Board (ASB), which has now been replaced by a less powerful body (the Accounting Council) which merely advises the FRC, which is independent of both the profession and the government.

The ASB was not given a monitoring or enforcement role. Instead a separate FRRP, which is also part of the FRC was established to monitor the financial statements of public and large private companies. All other companies are dealt with by the Department for Business, Innovation and Skills (BIS). When the Financial Services Authority (FSA) was established in 2000 by the Financial Services and Markets Act to regulate the financial services industry, it was given no part in enforcing compliance with accounting standards. The same applies to the Financial Conduct Authority (FCA) which took over from the FSA in 2013.

Between 1991 and 2003, the Financial Reporting Review Panel played an important role in examining the financial statements of public companies and large private companies for material departures from the Act and from accounting standards. It did not attempt to monitor all companies within its remit nor to be proactive, but restricted its investigations to companies brought to its attention. It achieved its aims by persuasion, although it had the power to apply to the court for a declaration that the financial statements of a company did not comply with the requirements of the Act (including giving a true and fair view) and for an order requiring the company's directors to prepare (and personally pay for) revised statements.

Hines *et al*. (2000) discussed the workings of the Panel during its first decade and assessed its effectiveness. They concluded that it was an effective regulator, concerned to establish its legitimacy, despite its limited powers. Peasnell *et al.* (2001) researched the characteristics of companies judged by the Panel to have published defective financial statements. They show that such companies were more likely to be suffering from performance difficulties in the defect year and less likely to have a Big-5 auditor. Weaker evidence suggested that the companies were less likely to have an audit committee and to have a high proportion of outside directors. Fearnley *et al.* (2002) showed that the FRRP changed the costs and benefits to auditors of permitting non-compliance. Although the Panel has regulatory authority over directors, not auditors, it has motivated auditors to improve accounting compliance and has

enhanced their independence. Brown and Tarca (2007) look at the FRRP's activities from 1998 to 2004. They conclude that the FRRP fulfilled its role, although it was subject to political forces, and they compare it to the quite different Australian approach (see Section 20.5).

The role of the Panel was reconsidered in the light of the Enron case and other accounting scandals. The FRRP was asked by the government to become more proactive and to explore ways of working with the FSA. From 2005 onwards one of the main tasks of the Panel has been to ensure compliance by listed companies with IFRS. The FRRP was given a wider remit and greater powers by the Companies (Audit, Investigations and Community Enterprise) Act of 2004. In particular, its operations were extended to cover interim as well as annual financial statements and the directors' report. Its remit also covers compliance with the accounting requirements of the FCA's listing rules for publicly traded companies.

The Panel selects statements for review both proactively and reactively. It discusses with the FCA and its own Standing Advisory Group which sectors of the economy are under strain or likely to give rise to difficult accounting issues. A number of financial statements are reviewed in the sectors thus selected. The Panel operates a risk model to identify cases where accounting problems are more likely, for example where corporate governance is poor. It looks at topical accounting issues, and responds to complaints from the public, from the press and from the City of London. All selections take account of the risk of non-compliance and the risk of significant consequences in the event of non-compliance. In 2008, the FRRP made 300 examinations, which led to 138 letters to companies requiring clarification, and eventually to two corrections of errors by prior period adjustment. Berger (2010, page 31) criticizes the FRRP for concentrating too much on omitted disclosures rather than on measurement issues.

The Panel does not operate a system of advance clearance. It usually makes an announcement at the conclusion of an enquiry if the directors of a company under review have agreed that their statements were defective and have been corrected or clarified, as specified by the Panel. No announcement is usually made when a report is found not to be defective, although the Panel may, without naming companies, issue 'generic' press notices about matters that have come to its attention. The Panel publishes an annual Activity Report.

The FRRP collaborates closely with the FCA. The UK tax authorities (HM Revenue and Customs) are authorized to disclose information regarding company accounts to the Panel.

Turning now to auditors, formal supervision of them in the UK began with the implementation of the EU Eighth Directive in the Companies Act 1989. The Act required that company auditors must be registered auditors, i.e. have their names inscribed as qualified for appointment on a statutory register maintained by recognized supervisory bodies. The main bodies so recognized (by the government department) were the three Institutes of Chartered Accountants and the Association of Chartered Certified Accountants. This legislation meant that the professional bodies had to supervise their members in the public interest, whilst at the same time continuing to serve the private interests of those members.

This combination of roles can lead to a conflict of interest, and in 1998 a Regulation Review Implementation Working Party of the Consultative Committee of

the Accountancy Bodies (CCAB) proposed the establishment of an independent Review Board. Five bodies were set up: an Accountancy Foundation, a Review Board, an Ethics Standards Board (ESB), a reformed Auditing Practices Board (APB), and an Investigation and Discipline Board (IDB). The Foundation was given an over-arching responsibility; the Review Board's task was to monitor the operation of the system to confirm that it met the public interest; the ESB had the role of securing the development on a profession-wide basis of ethical standards for all accountants; and the IDB dealt with disciplinary cases of public concern. The APB was reconstituted to be independent of the accountancy profession. Dewing and Russell (2002) pointed out that the Accountancy Foundation had direct responsibility for discipline (via the IDB), indirect responsibility for auditor independence (via the ESB) but no responsibility for monitoring audit quality.

The system thus set up was not seen as very successful and was reformed in 2002. Under the reformed system six operating bodies were responsible to the FRC: the ASB, the APB, the FRRP, the Professional Oversight Board (POB), the Board for Actuarial Standards, and an Accountancy and Actuarial Investigation and Discipline Board (AAIDB). Yet further reform happened in 2012. Now the FRC itself issues all standards. It is advised by its Codes and Standards Committee, which itself has three councils to advise it: on audit, accounting and actuarial practice. On the audit side, the FRC is responsible for the issue of, *inter alia*, auditing standards (ISAs [UK and Ireland]), ethical standards, standards for investment reporting (SIRs), and statements of standards for reporting accountants. The other operations (including the FRRP) come under the FRC's Conduct Committee, whose responsibilities include overseeing the regulation of auditors by the recognized supervisory bodies, monitoring the quality of the audits of economically significant entities, and overseeing the regulation of the accountancy profession by the professional accountancy bodies.

The Companies Act 2006 introduced a requirement that audit reports be signed for and on behalf of the audit firm by the senior statutory auditor (the partner in charge of the audit). It also allowed for the first time companies and their auditors to enter into liability limitation agreements that limit the auditors' liability to what is fair and reasonable. Rotation of auditors is not required by the Act.

Compliance with standards by individual companies is left largely to auditors and so is much more weakly monitored than compliance with IFRS by groups. Furthermore, many private companies are no longer required to be audited (see Chapter 14).

20.4.3 France

The enforcement body in France is the *Autorité des Marchés Financiers* (AMF, Financial Markets Authority), established in 2003 by the merger of the *Commission des Opérations de Bourse* (COB, Stock Exchange Commission) and two other stock exchange regulatory bodies. The AMF is responsible for the enforcement of the application of IFRS by listed companies. It is not a standard-setting body.

The AMF can draw upon the procedures set in place by COB, which was established in 1967. These were described by Dao (2005). Acting as a stock exchange regulator, the AMF reviews prospectuses and the documents lodged annually (compulsorily or voluntarily) by listed companies. It carries out a general review of the legal, economic and financial aspects of the documents. Its role is to identify issues considered to be

important and then to ask legal and accounting specialists to carry out further examination. The AMF verifies the compliance of the documents with applicable accounting standards and supervises the quality of the audit.

The AMF follows a proactive risk-based approach in selecting which companies to investigate, but also on occasion follows up press comments and complaints. The AMF uses both advance clearance and post-lodgement reviews. The AMF carries out studies to identify companies likely to be affected by emerging issues. It issues recommendations, without naming companies, to notify registrants of the need to comply with particular accounting treatments or disclosures. Such recommendations are not mandatory but they are usually followed.

A notorious example of pre-clearance by the AMF occurred in early 2008 and concerned the French bank, Société Générale. The bank wished to charge a €6.4 bn loss caused by 'rogue trading' in the 2007 income statement rather than in 2008. This involved breaking IAS 10, IAS 37 and IAS 39 on the grounds of the need to give a fair presentation under IAS 1. The bank explained (in its Registration Document, 2008, page 247) that this treatment had been approved by the AMF. Not surprisingly, it was then approved by the auditors.

The AMF has power to refuse to approve a prospectus and to require companies to make changes to their financial statements if in its opinion they did not comply with applicable standards. It can take administrative action against a company, although this rarely proved necessary. It is easier to detect non-compliance with disclosure rules than with measurement rules, which are more difficult for an oversight body to detect than for an auditor. Berger (2010) reports that the AMF looks at the financial statements of the 140 largest companies once every three years, and other listed companies once every five years. In 2008, AMF made 150 examinations but, until recently, there was no information available about the number of errors found. Like the SEC, but unlike the FRRP, the AMF did not issue press releases on the outcome of its enquiries, or name companies whose statements have been found to be defective. However, starting in 2015, information on investigations is now publicly available (http://www.amf-france.org).

Supervision of company audit is achieved in a number of ways. All auditors are required to be members of the *Compagnie Nationale des Commissaires aux Comptes*. The *Loi de Sécurité Financière* (Financial Security Law) of 2003, enacted partly as a result of a continuing review of French commercial law but also in response to Enron and other scandals (Stolowy, 2005), set up the *Haut Conseil de Commissariat aux Comptes* (H3C, Statutory Auditing High Council), which is external to the audit profession, and only three of whose 12 members are *commissaires aux comptes*. The function of the H3C is to supervise the profession, in particular its ethics and independence. The 2003 Law also requires a new report by the auditors on internal control systems and prohibits the provision of both auditing and consulting services to the same client.

Other differences from US and UK rules include:

- auditors are appointed for a six-year term, rather than annually;
- for companies presenting consolidated as well as individual financial statements, there must be at least two auditors, drawn from different firms;
- auditors must disclose to the public prosecutor any criminal acts by an audit client of which they become aware.

French regulations as to activities regarded as incompatible with the conduct of a statutory audit have been more restrictive than those in the UK and the US, although in practice the differences have not been great (Mikol and Standish, 1998).

20.4.4 Germany

As noted in Section 20.4.1, enforcement of accounting rules used to be weak in Germany, both for AGs (public companies) and GmbHs (private companies). Before 1985, only AGs and very large GmbHs were required to publish their financial statements. Since the *Bilanzrichtliniengesetz*, Accounting Directives Law, 1985, many more GmbHs have been required to do so as a result of the implementation of the EU Fourth Directive (Eierle, 2005), but many failed to do so until the German government was forced into action by the EU Commission.

Between 1998 and 2005 listed AGs (and between 2000 and 2005 all entities that raised money on the equity market) were permitted (and some were required) to apply either US GAAP or IASs in their consolidated financial statements instead of German rules. As noted earlier, Glaum and Street (2003) tested compliance with IAS in the year 2000 financial statements of companies listed on the *Neuer Markt* (New Market). They reported considerable non-compliance, but that the highest compliance rates related to audit by the Big-5 audit firms and companies which were also listed on a US exchange and thus subject to SEC surveillance. These results were consistent with previous research by Street and Bryant (2000) and Street and Gray (2001) (see Section 20.4.1).

The weakness in compliance triggered a discussion in Germany of the relative merits of the US and UK models of enforcement: the SEC and the FRRP. In 2001, the *Institut der Wirtschaftsprüfer* (IdW) proposed an enforcement body modelled on the FRRP. An SEC-type body was seen by the IdW as contrary to the trend in Germany towards deregulation and more private-sector involvement (Evans *et al.*, 2002). However, a compromise between the US and UK precedents was enacted in 2004. The *Bilanzkontrollgesetz* (BilKoG, Financial Reporting Control Act) and the *Bilanzrechtsreformgesetz* (BilReG, Accounting Law Reform Act) established a new regulatory framework for financial reporting. A two-tier enforcement regime was established, with two enforcement bodies, one private and one public. The philosophy of the legislation is that unlawful practice will be prevented by the existence of the regulatory framework rather than by the taking of specific actions. The private body was set up in 2005 as the *Deutsche Prüfstelle für Rechnungslegung* (DPR) (Financial Reporting Enforcement Panel, FREP). It reports to the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Institute for the Oversight of Financial Services). The BaFin is a stock exchange regulator with similar functions to the FCA in the UK. As a public body it acts as a supervisor of FREP's activities and has the power to re-examine a company's financial statements. A company which refuses to change its accounting treatment can be fined €50,000, an amount not large enough to act as much of a deterrent.

Berger (2010) examined the DPR/FREP in some detail. It reviews the financial statements of the top 160 companies every four to five years, and the others every eight to ten years. In 2008, there were 138 examinations, leading to the discovery of 37 errors, most of which were made public. Ernstberger *et al.* (2012) find that there were improvements in the quality of accounting among firms covered by the FREP. This was evidenced by decreased earnings management and increased share liquidity.

Hitz *et al.* (2012) study the 'error findings' made by FREP and issued by BaFin between 2005 and 2009. They conclude that the market responded to the negative information contained in them.

If an audit firm's behaviour has been called into question, the BaFin can refer it to the *Wirtschaftsprüferkammer* (WPK), the private-sector body responsible for the regulation of the audit profession. The WPK deals with minor violations of professional rules; severe violations are dealt with in the criminal courts. Since 2005, all decisions of the WPK are subject to the public oversight of the Auditor Oversight Commission (*Abschlussprüferaufsichtskommission*, APAK), a body in the public sector.

20.5 West Pacific Rim

20.5.1 Introduction

The above sections examine regulation in the United States and the European Union. As Table 1.5 shows, several other large stock markets in the world are on the Asian side of the Pacific: Tokyo, Shanghai and Sydney. This section examines regulation of financial reporting in those markets.

The common feature of regulation in Australia, China and Japan is that it is all based on the model of the SEC of the United States. The Hong Kong market is regulated by its own separate authority.

20.5.2 Australia

The monitoring and enforcement of compliance with accounting standards by listed companies is one of the functions of the ASIC (Brown and Tarca, 2007). The ASIC was created in 1998 as the successor to the Australian Securities Commission which had been set up by the Australian federal government in 1990 on the model of the SEC. The ASIC has a close working relationship with the Australian Stock Exchange (ASX).

In carrying out its monitoring and enforcement function the ASIC has always been a proactive body, drawing on a broad range of sources of information, including its own surveillance programme. Currently, each listed company is reviewed every four years. In addition, targeted surveillance is conducted on issues considered to pose a particular risk. For example, dot.com companies were targeted in 2001.

The actions of the ASIC have generated much press publicity. The most common remedial action required has been revision of accounts, published in a subsequent annual report. Like the FRRP in the UK, the ASIC has the power to take a company to court and, unlike its UK counterpart, has done so on a number of occasions, although it prefers other remedies where possible. The ASIC has itself been taken to court by companies that disagreed with its rulings. Companies involved in ASIC cases between 1998 and 2004 were less profitable and less likely to have a Big-4 auditor than companies in a matched control sample (da Silva Rosa *et al.*, 2008).

Further discussion of the activities of the ASIC and a comparison with the FRRP is provided by Brown and Tarca (2005b, 2007). In 2003 the ASIC proposed the setting up of an Australian Financial Reporting Panel as a consensual way of resolving

disputes. The panel commenced work in 2006. The intention is to complement the activities of the ASIC, not substitute for them. So, the panel does not conduct surveillance, and it avoids legal actions.

The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 replaced the self-regulation of auditors by the professional bodies with a system of supervision of auditors by the Financial Reporting Council and the ASIC. The former is responsible for monitoring the independence of auditors, the latter for their registration. The Act also introduced a number of changes to promote auditor independence, including restrictions on auditors being employed by an audit client, prohibition of some non-audit services for an audit client, and five-year rotation of audit lead and review partners.

20.5.3 China

The China Securities Regulatory Commission (CSRC) was established in 1992 as a ministry-level state institution. The Securities Law of 1998 gives it wide powers in the monitoring and enforcement of markets, including the financial reporting of listed companies. The CSRC drafts laws about securities markets, supervises the issue and trading of stocks, supervises the behaviour of listed companies and exchanges, examines and approves the qualifications of auditors, and investigates and penalizes infringements of the laws.

20.5.4 Japan

The Financial Services Agency of Japan was established in 1998 and now reports to the Cabinet Office. It has similar tasks to those of the SEC in the United States. The Financial Services Agency includes the Certified Public Accountants and Auditing Oversight Board which was set up in 2004 to supervise audits. The Financial Services Agency staff review all the filings from companies to check for compliance with the requirements, and to check auditors' opinions.

The Financial Services Agency has been in charge of allowing the use of IFRS for certain companies since 2010. The conditions for this have been gradually loosened, and the FSA issued a report in 2015 on progress (see Chapter 11).

SUMMARY

- Enforcement of accounting standards requires, inter alia, statutory audit, monitoring by supervisory bodies and effective sanctions.
- Making rules is conceptually distinct from enforcing them but the roles may sometimes be combined in practice.
- Enforcement may be carried out by stock exchanges, regulators of stock exchanges, government departments and agencies, or private-sector bodies.
- Modes of enforcement differ from country to country, partly as a function of the local environment.
- The supervision (oversight) of auditors may strengthen the hand of auditors against directors.

- The powers and operating procedures of enforcement bodies differ from country to country.
- The strictest and best-resourced enforcement regime is that of the Securities and Exchange Commission in the US. Auditors in the US are supervised by the Public Company Accounting Oversight Board.
- There are no EU-wide enforcement or oversight bodies; enforcement and supervision are weak in many member states. Cooperation among national regulators takes place through European Enforcers' Co-ordination Sessions and the European Group of Auditors' Oversight Bodies.
- In the UK, the Financial Reporting Review Panel of the Financial Reporting Council, a private-sector body, has been an effective enforcer of accounting standards from 1991 onwards. It has close links with the stock exchange regulator, the Financial Conduct Authority.
- In France, the enforcement body is the stock exchange regulator, the *Autorité des Marchés Financiers*, which is proactive and uses advance clearance as one of its operating procedures. For review of audit quality, it relies on the *Compagnie Nationale des Commissaires aux Comptes*, which is responsible for the registration of auditors and is supervised by the *Haut Conseil des Commissaires aux Comptes*.
- In Germany, enforcement of accounting standards is shared between the stock exchange regulator (BaFin) and a private-sector Financial Reporting Enforcement Panel. The *Wirtschaftsprüferkammer* is responsible for the registration of auditors. It is supervised by the *Abschlussprüferaufsichtskommission*.
- In Australia, accounting standards are enforced by the stock exchange regulator, the Australian Securities and Investments Commission (ASIC), which is proactive and has taken legal action against several companies. Auditors are supervised by the ASIC and the Financial Reporting Council.

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Useful websites

Abschlussprüferaufsichtskommission (APAK) (Germany)	www.apak-aoc.de
Australian Securities and Investments Commission	www.asic.gov.au
Authority for the Financial Markets (Netherlands)	www.autoriteit-fm.nl
Autorité des Marchés Financiers (France)	www.amf-france.org
Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	www.bafin.de
China Securities Regulatory Commission	www.csrc.gov.cn
Compagnie Nationale des Commissaires aux Comptes (France)	www.cncc.fr
Department for Business, Innovation and Skills (UK)	www.bis.gov.uk
Deutsche Prüfstelle für Rechnungslegung (Financial Reporting Enforcement Panel) (Germany)	www.frep.info
European Group of Auditors' Oversight Bodies	http://ec.europa.eu/internal_market/auditing/egaob
European Securities and Markets Authority	www.esma.europa.eu
Fédération des Experts Comptables Européens	www.fee.be
Financial Conduct Authority (UK)	www.fca.gov.uk
Financial Reporting Council	www.frc.org.uk
Financial Services Agency (Japan)	www.fsa.go.jp
Haut Conseil du Commissariat aux Comptes (France)	www.h3c.org
Public Company Accounting Oversight Board (US)	www.pcaobus.org
Securities and Exchange Commission (US)	www.sec.gov

QUESTIONS

Suggested answers to the asterisked questions are given at the end of the book.

20.1* To what extent is the making of rules on financial reporting in the US separated from their enforcement? What is the historical background to the present situation?

20.2* What are the arguments for and against proactive surveillance by enforcement bodies?

20.3 Why is there no pan-European accounting standards enforcement body in the European Union? Ought one to be established?

20.4 Why do the US and France have stock exchange regulators as accounting standards enforcement bodies, whereas the UK does not?

20.5 Discuss the view that the costs of establishing and maintaining accounting standards enforcement bodies are likely in most countries to exceed the benefits.

20.6 'Enforcement bodies merely duplicate the work of auditors.' Discuss.

20.7 Why have several countries recently introduced auditor oversight bodies? Is this a positive or a negative development?

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Synoptic table of accounting differences in eight GAAPs, 2015

The following table lists the requirements relating to 22 accounting topics in eight GAAPs for 2015, typically for 31 December 2015 year ends, but for Japan 31 March 2016 year ends.

The table looks at rules rather than practices. There is much discussion of the importance of the difference between the two in several chapters of Parts I and II of this book.

A few notes on each of the GAAPs are relevant to understanding the table:

1 *IFRS*. This column relates to IFRS as issued by the IASB, although there are no relevant differences for the 22 topics between this and EU-endorsed IFRS or Australian or Canadian versions of IFRS.

2 *US*. This column relates to US GAAP, which is compulsory for the consolidated statements of US registrants with the SEC.

3 *Japan*. This column relates to the requirements for consolidated statements under the Companies Act and the Securities Law.

4 *China*. The rules here relate to the consolidated statements of listed companies, using the ASBE standards which are based on IFRS.

5 *France*. This column relates to French national rules, which are required for unconsolidated statements. In a few cases (shown with an asterisk), the rules would be different for consolidated statements under national rules. Readers will remember that, for the consolidated statements of listed companies, EU-endorsed IFRS is required.

6 *Germany*. This column relates to German national rules, which are required for unconsolidated statements (even if IFRS statements are also prepared for filing). Readers will remember that, for the consolidated statements of listed companies, EU-endorsed IFRS is required.

7 *UK*. This column relates to UK national rules, which are allowed for purposes other than the consolidated statements of listed companies (which must use EU-endorsed IFRS).

8 *IFRS for SMEs*. These are the rules in the IFRS for SMEs as issued by the IASB in 2009 and amended in 2015. In certain jurisdictions (e.g. Hong Kong), some amendments have been made.

Synoptic Table of Accounting Differences in Eight GAAPs, 2015

	Topic	IFRS	US	Japan	China (ASBE)	France	Germany	UK	IFRS for SMEs
1.	Balance sheet starts with cash	Option	Yes	Yes	Yes	No	No	No	Option
2.	LIFO allowed?	No	Yes	No	No	No*	Yes, under some circumstances	No	No
3.	Can PPE be re-measured above cost?	Yes	No	Not generally	No	No*	No	Yes	Yes
4.	Investment property re-measured above cost	Option	No	No	Option	No*	No	Yes	Yes, if measurable
5.	Finance leases capitalized?	Yes	Yes	Yes	Yes	No*	Mostly not	Yes	Yes
6.	Development costs capitalized (when meeting criteria)	Yes	No, except software	No, except software	Yes	Option	Option	Option	No
7.	Pre-operating costs capitalized	No	No	No	No	Option	Option	No	No
8.	Marketable securities fair valued	Yes	Yes	Yes	Yes	No*	No	Yes	Yes
9.	Derivatives recognized	Yes	Yes	Yes	Yes	No	No	Yes	Yes
10.	Goodwill	Impairment	Impairment	Amortization	Impairment	Amortization	Amortization	Amortization	Amortization
11.	Impairment tests	DCF (or net selling price)	Undiscounted cash flows	Undiscounted cash flows	DCF (or net selling price)	No detailed rule	No detailed rule	DCF (or net selling price)	DCF (or net selling price)

12. Impairment losses reversed when suitable	Yes	No	No	No	Yes	Yes	Yes	Yes
13. Pension liabilities must be fully recognized	Yes	Yes	Yes	No	No	No	Yes	Yes
14. Actuarial gains/losses fully to OCI	Yes	No	No	No rule	No	No	Yes	Option
15. Provisions discounted	Yes	Mostly not	Mostly not	Yes	No	Yes	Yes	Yes
16. Unsettled currency gains to income	Yes	Yes	Yes	Yes	No	Only some	Yes	Yes
17. % of completion method for suitable contracts	Restricted	Restricted	Yes	Yes	No	No	Yes	Yes
18. Interest on construction capitalized	Yes	Yes	Mostly not	Yes	Option	No	Option	No
19. Extraordinary items definition	None	None	Narrow	None	Wide, vague	Vague	None	None
20. OCI presentation in statement required	Yes	Yes	Yes	Yes	No	No	Yes	Yes
21. Policy changes and error corrections in income	No	No	No	No	Yes	Yes	No	No
22. Proportional consolidation of JVs in consolidated statements	No	In some industries	No	Option	Required	Option	No	No

*For unconsolidated statements

Glossary of abbreviations

This glossary contains abbreviations of bodies, documents, etc. We include international terms and those relating to the countries to which we refer in detail in Parts II–IV of the book.

Australia

AARF	Australian Accounting Research Foundation
AAS	Australian Accounting Standard
AASB	Australian Accounting Standards Board
ASIC	Australian Securities and Investments Commission
ASRB	Accounting Standards Review Board
AuASB	Auditing and Assurance Standards Board (of the AARF)
AUP	Statement of Auditing Practice
CA ANZ	Chartered Accountants Australia and New Zealand
CPAA	CPA Australia
FRC	Financial Reporting Council
LRB	Legislation Review Board (of the AARF)
SAC	Statement of Accounting Concepts
UIG	Urgent Issues Group

East Asia

AFA	ASEAN Federation of Accountants
AOSSG	Asian-Oceanian Standard Setters Group
ASBJ	Accounting Standards Board (Japan)
BAC	Business Accounting Council (Japan)
BADC	Business Accounting Deliberation Council (Japan)
CICPA	Chinese Institute of Certified Public Accountants
CSRC	China Securities Regulatory Commission
HKICPA	Hong Kong Institute of Certified Public Accountants
JICPA	Japanese Institute of Certified Public Accountants
KICPA	[South] Korean Institute of Certified Public Accountants
KK	Kabushiki Kaisha (Japanese joint stock company)
YK	Yugen Kaisha (Japanese private company)

France

AMF	Autorité des Marchés Financiers
ANC	Autorité des Normes Comptables
CENA	Comité de l'Examen National des Activités
CNC	Conseil National de la Comptabilité
CNCC	Compagnie Nationale des Commissaires aux Comptes
COB	Commission des Opérations de Bourse
CRC	Comité de la Réglementation Comptable
CGI	Code général des impôts
H3C	Haut Conseil du Commissariat aux Comptes
OEC	Ordre des Experts-Comptables
PCG	Plan comptable général
SA	Société anonyme
SARL	Société à responsabilité limitée

Germany

AG	Aktiengesellschaft
AktG	Aktiengesetz
APAK	Abschlussprüferaufsichtskommission
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
BiLiRiG	Bilanzrichtliniengesetz
BilKoG	Bilanzkontrollgesetz
BilMoG	Bilanzrechtsmodernisierungsgesetz
BilReG	Bilanzrechtsreformgesetz
DPR	Deutsche Prüfstelle für Rechnungslegung
DRSC	Deutsches Rechnungslegungs Standards Committee
EStG	Einkommensteuergesetz
EStR	Einkommensteurerrichtlinien
FREP	Financial Reporting Enforcement Panel
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GoB	Grundsätze ordnungsmässiger Buchführung
HGB	Handelsgesetzbuch
IdW	Institut der Wirtschaftsprüfer
KapAEG	Kapitalaufnahmeerleichterungsgesetz
KG	Kommanditgesellschaft
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich
OHG	Offene Handelsgesellschaft

PublG	Publizitätsgesetz
WP	Wirtschaftsprüfer
WPK	Wirtschaftsprüferkammer

United Kingdom and Ireland

ACCA	Association of Chartered Certified Accountants
AIDB	Accountancy Investigation and Discipline Board
APB	Auditing Practices Board
APC	Auditing Practices Committee
ASB	Accounting Standards Board
ASC	Accounting Standards Committee
ASSC	Accounting Standards Steering Committee
BIS	Department of Business, Innovation and Skills
CCAB	Consultative Committee of Accountancy Bodies
CGAA	Co-ordinating Group on Audit and Accounting Issues
CIMA	Chartered Institute of Management Accountants
CIPFA	Chartered Institute of Public Finance and Accountancy
DTI	Department of Trade and Industry
ED	Exposure Draft
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FRED	Financial Reporting Exposure Draft
FRRP	Financial Reporting Review Panel
FRS	Financial Reporting Standard
FRSSE	Financial Reporting Standard for Smaller Entities
FSA	Financial Services Authority
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants in Ireland
ICAS	Institute of Chartered Accountants of Scotland
PLC	Public limited company
POB	Professional Oversight Board
SAS	Statement of Auditing Standards
SORP	Statement of Recommended Practice
SSAP	Statement of Standard Accounting Practice
UITF	Urgent Issues Task Force
UK GAAP	UK generally accepted accounting practice
UKSIP	UK Society of Investment Professionals

European

ARC	Accounting Regulatory Committee
CESR	Committee of European Securities Regulators
EECS	European Enforcers Co-ordination Sessions
EEIG	European Economic Interest Grouping
EFRAG	European Financial Reporting Advisory Group
EGAOB	European Group of Auditors' Oversight Bodies
ESMA	European Securities and Markets Authority
EU	European Union
FEE	Fédération des Experts Comptables Européens
FSAP	Financial Services Action Plan
SARG	Standards Advice Review Group
SMEs	Small and medium-sized entities

United States

AAA	American Accounting Association
ADR	American Depositary Receipt
AICPA	American Institute of Certified Public Accountants
AIMR	Association for Investment Management and Research
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
ASR	Accounting Series Release (of the SEC)
CFA	Chartered financial analyst
EITF	Emerging Issues Task Force
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FRR	Financial Reporting Release
GAAP	Generally accepted accounting principles
GAAS	Generally accepted auditing standards
GASB	Government Accounting Standards Board
IRS	Internal Revenue Service
PCAOB	Public Company Accounting Oversight Board
SAB	Staff Accounting Bulletin (of the SEC)
SARBOX	Sarbanes-Oxley Act
SEC	Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts
SFAS	Statement of Financial Accounting Standards
SOX	Sarbanes-Oxley Act
VIE	Variable interest entity

Other international

AAC	African Accounting Council
AISG	Accountants' International Study Group
AOSSG	Asian-Oceanian Standard Setters Group
ASAF	Accounting Standards Advisory Forum
CAPA	Confederation of Asian and Pacific Accountants
ECSAFA	Eastern, Central and Southern Africa Federation of Accountants
FSB	Financial Stability Board
GLASS	Group of Latin American Standard Setters
IAA	Interamerican Accounting Association
IAASB	International Auditing and Assurance Standards Board
IAPC	International Auditing Practices Committee
IAPN	International Audit Practice Note
IAPS	International Audit Practice Statement
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
ICCAP	International Coordination Committee for the Accountancy Profession
IFAC	International Federation of Accountants
IFAD	International Forum for Accounting Development
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IOSCO	International Organization of Securities Commissions
ISA	International Standard on Auditing
ISAE	International Standard on Assurance Engagements
ISQC	International Standard on Quality Control
ISRE	International Standard on Review Engagements
ISRS	International Standard on Related Services
NPAEs	Non-publicly accountable entities
NSS	National standard-setters
OECD	Organisation for Economic Co-operation and Development
PIOB	Public Interest Oversight Board (of IFAC)
SIC	Standing Interpretations Committee (of the IASC)
SME	Small and medium-sized entity
SMEIG	Small and Medium-sized Entities Implementation Group (of the IFRS Foundation)
UNCTAD	United Nations Council on Trade and Development

UNO	United Nations Organization
WTO	World Trade Organization

Principles, methods and financial statements

CCA	Current cost accounting
CNC	Current/non-current
CRC	Current replacement cost
DCF	Discounted cash flows
FIFO	First-in, first-out
HCA	Historical cost accounting
LIFO	Last-in, first-out
MNM	Monetary/non-monetary
MD&A	Management's discussion and analysis
NRV	Net realizable value
OCI	Other comprehensive income
OFR	Operating and financial review
PPE	Property, plant and equipment
SCE	Statement of changes in equity
SCI	Statement of comprehensive income
SORIE	Statement of recognized income and expense
STRGL	Statement of total recognized gains and losses

Further reading

More definitions and abbreviations may be found in:

Nobes, C.W. (2006) *The Penguin Dictionary of Accounting*, Penguin, 2nd edn, London.

Parker, R.H. (1992) *Macmillan Dictionary of Accounting*, Macmillan, 2nd edn, London.

Suggested answers
to some of the end-of-chapter questions

CHAPTER 1

1.1

Question How has financial reporting been affected by major political and economic events in the world since the end of the Second World War?

Answer The domination by the US of the non-communist post-war world meant that capitalist countries were strongly influenced by US GAAP, especially as propagated by the international accounting firms. Countries such as Canada and Australia were especially open to US influence. However, despite the break-up of the British Empire, British-style accounting continued in countries such as India and Nigeria. Similarly, former colonies of France and other European countries continue to follow the accounting styles of the former imperial power.

The creation and expansion of the European Union from 1958 onwards helped to preserve continental European accounting concepts and practices, albeit increasingly diluted after the entry of the UK in 1973. The creation of the International Accounting Standards Committee (now succeeded by the International Accounting Standards Board), also in 1973, can be seen politically both as an attempt to counter US influence and as an attempt to infiltrate Anglo-Saxon concepts and practices into Europe and elsewhere. The UK in this respect, as in many others, found itself torn between the USA and Europe.

Central and Eastern European countries dominated by the USSR, the other post-war political superpower, used communist accounting until the collapse of Soviet power from 1989 onwards. All have undergone rapid accounting change and many joined the EU from 2004 onwards. They have reverted to continental European accounting but imported IFRS for their listed companies. An incidental effect of the political imperative of the reunification of West and East Germany was a temporary weakening of the German economy, a consequent greater need to seek capital on world capital markets, and the adoption of US GAAP or IFRS by German multinationals.

In East Asia, US-style institutions were introduced into occupied Japan after the Second World War, but were much modified after Japan regained its political and economic independence. The political decision of the Chinese government to move its economic system closer to capitalism led to corresponding changes in its accounting systems, leading up to approximate adoption of IFRS for listed companies from 2007.

In the 2000s, the collapse of Enron and Andersen undermined the respectability of US accounting. The Sarbanes-Oxley Act that resulted from the collapses made New York a less attractive capital market. This contributed to the acceptance of IFRS in the USA, in order to reduce the burdens on foreign registrants. However, the economic crisis of 2008 helped President Obama win the election and the new administration and the SEC (Securities and Exchange Commission) that it appointed have been less keen to accept 'foreign' accounting for US companies.

1.2

Question Why have the major accounting firms become 'international'? From what countries have they mainly originated? Why?

Answer The major firms are 'international' because, in order to stay in the top group of firms, they had to follow their multinational clients around the world, either by setting up local offices or by

merging with or taking over existing local firms. The firms mainly originate from those home countries of MNEs that have well-developed accountancy professions, notably the United Kingdom and the United States. Other home countries of MNEs and international accounting firms are Canada, the Netherlands, Germany and Japan (see Tables 1.11 and 1.12 in Chapter 1). The last two do not have such well-developed accountancy professions; the first two countries are much smaller commercially than the United Kingdom or United States.

A more sophisticated answer will be possible after study of Chapter 19 (International auditing).

CHAPTER 2

2.1

Question 'The basic cause of international differences in financial reporting practices is the different degree of interference by governments in accounting.' Discuss.

Answer Financial reporting practices in any given country may differ because the needs of users of accounting information differ. For example, tax authorities may stress objectivity, banks with secured loans may stress conservatism, and shareholders may stress the predictability of future cash flows. Unlike loan creditors and shareholders, tax authorities have the force of government power to back up their demands and are likely to dominate financial reporting if unopposed. In countries such as the United States and the United Kingdom, the needs of capital markets have been more influential but, where the market is perceived to fail, as in the United States in the years after 1929, 2001 and 2008, and in the United Kingdom in the 1960s, governments have 'interfered' on behalf of shareholders. Nevertheless, the style of financial reporting imposed by government bodies will probably reflect the strength of the capital markets.

Furthermore, strong capital markets may lead to commercial accounting which is largely outside of government control. For example, in Germany in 1998, the law was changed after corporate pressure to allow listed companies to depart from normal German principles in their consolidated statements.

Within the EU, the national differences in rules are now confined largely to unconsolidated financial reporting. Governments, through the EU legal apparatus, have interfered jointly to require IFRS for the consolidated statements of listed companies. However, even within IFRS, there is scope for different national versions of practice.

Professional accountants as well as governments can be seen by some observers to be interfering in financial reporting practices. In the words of a former French finance (later prime) minister, as reported in the OECD's Harmonization of Accounting Standards, 1986, pages 9–10:

> Standardization procedures vary from country to country. Sometimes specific standards applying to each of the main problems taken in isolation are worked out by the accounting profession, which may consult other interested parties but remains solely responsible for the decisions taken. On the contrary, accounting may be purely and simply government-regulated. Lastly, an intermediate method is adopted in some countries, including France, with systematic consultations among all the parties concerned. In many cases a consensus can be reached. Where this is not possible, government intervention preserves the public interest. It seems to us to be perfectly reasonable that the government should have the last word in deciding on the main points of standardization and make sure that no one interest group can 'lay down the law' to others.

2.2

Question Assess the view that accidents of history are primarily responsible for international differences in corporate financial reporting.

Answer Some international differences can, indeed, apparently be explained only by 'accidental' or 'exogenous' historical factors that are unconnected with accounting. Examples are:

- the 'import' into developing countries of apparently unsuitable financial reporting practices from colonial powers (compare, for example, the former British and French colonies in Africa);
- acceptance of 'alien' accounting ideas by EU member states as part of a political package; and
- the influence of occupying powers (e.g. Germany on France, United States on Japan).

For a country that is heavily influenced by another (e.g. because of a former colonial relationship), this single 'accident' may be the major influence on the style of accounting found in a country. However, in other countries, accounting may be driven by the type of capital market and the nature of regulation. (See also the answer to Question 2.1.)

CHAPTER 3

3.1

Question In what ways might classification be useful in any field of study? Use international differences in financial reporting as an illustration of your answer.

Answer As the chapter suggests, classification might be helpful to:

(a) sharpen description and analysis;
(b) reveal underlying structures;
(c) enable prediction of properties of an item from its position in a classification;
(d) predict missing items;
(e) trace the evolution of items.

In international accounting, this might mean that a classification would help to:

(a) summarize the mass of data on differences;
(b) provide a feel for the accounting of one country based on analogies with others;
(c) estimate the difficulties of harmonization;
(d) chart the progress of harmonization;
(e) predict problems by analyzing similar countries;
(f) identify where to look for similar countries that might have already solved one's own problems.

3.2

Question 'The essential problems of attempts to classify financial reporting practices across the world are related to the suitability of the data upon which such classifications have been based.' Comment.

Answer Many classifications have been based on data which were not compiled for the purpose of classification. For example, reliance on data in Price Waterhouse surveys of the 1970s, with all questions given equal weight, might lead to the problem that important questions are swamped by unimportant ones. Also, one has to ask whether the data relate to all companies or mainly to Price Waterhouse (as it was then) clients. Further, it seems likely that different questions would be asked by a German compiler compared with an American compiler. There are also many examples of errors in these databases. These include the much later data compiled from KPMG information. The net result may be merely classifications of the curious data rather than of the countries' accounting systems.

Of course, not all classifications have used these sorts of data. Scientists in other areas put a great deal of judgement into choosing which characteristics to measure for the purpose of classifications. Some accounting studies have also done that. Correct data on relevant criteria will lead to better classifications.

The question asks about 'essential problems'. There are, of course, problems other than data. For example, it is vital to decide what the purpose of the classification is, and what exactly is being classified. These points are even more 'essential'.

CHAPTER 4

4.1

Question Was the IASC successful? Explain your reasoning.

Answer Success could be looked for in several areas. This question is fairly well covered in the chapter. The question implies that we should study the period up to 2001, when the IASC was replaced by the IASB.

An answer might include reference to whether we look at the IASC's stated objectives or invent our own criteria for success. Indications of success before 2001 could relate to:

(a) issue of standards;
(b) refinement of standards;
(c) backing from other international bodies (e.g. IOSCO (International Organization of Securities Commissions) endorsement in 2000);
(d) backing from national bodies (e.g. the London Stock Exchange, Italy's CONSOB and the SEC);
(e) use of IASs as a basis for rule-making by some national standard-setters (e.g. Hong Kong, Singapore, Nigeria);
(f) use of IASs by certain large companies in the absence of national rules (e.g. fully in Switzerland, and partially in Italy);
(g) use of IASs by certain large companies for consolidated statements instead of national rules (e.g. Germany);
(h) acknowledgement of conformity with IASs by companies (e.g. in Canada);
(i) influence of IASC in shaping the debate elsewhere (e.g. EU Seventh Directive);
(j) compulsory use in the EU for the consolidated statements of listed companies (announced as a proposal by the Commission in 2000).

4.2

Question Which parties stand to gain from the international harmonization of accounting? What have they done to achieve it?

Answer This question is addressed in the chapter. The beneficiaries might be split into (a) users and (b) preparers. Governments might be seen to be users for the purposes of tax collection, but they also might wish to help users and preparers. The same applies to inter-governmental organizations, such as the EU.

Users include investors and lenders who operate across national borders. These would include institutions, such as banks. Companies, in their capacity as purchasers of shares in other companies or as analysts of suppliers or customers, would also gain from harmonization.

Preparers of multinational financial statements would gain from simplifications, and they would also benefit as users of their own accounting information from various parts of the

group. Accountancy firms are sometimes seen as beneficiaries but at present they gain work as auditors and consultants from the existence of international differences.

In terms of who did what to bring about harmonization, the picture is initially confusing, because the greater beneficiaries seemed to be doing little. That is, users are not sufficiently aware or sufficiently organized to address the problem. Preparers are too busy to act because they are trying to cope with, or to take advantage of, all the differences. However, some senior businessmen put public and private pressure on accountants to reduce differences. This is most notable in the case of companies such as Shell which are listed on several exchanges and try to produce one annual report for all purposes.

Governments have acted. For example the harmonization programme in the EU was active in the 1970s and 1980s. Also, the IOSCO is a committee of government agencies which began in the late 1980s to put considerable backing behind the IASC.

Perhaps the harmonizing body with the highest profile from the 1990s was the IASC which was a committee of accountancy bodies, largely controlled by auditing professions. Of course, the international differences do severely complicate the work of some auditors. However, there is an element of paradox in the fact that auditors are the most active in trying to remove lucrative international differences. However, the IASC was set up and run by very senior members of the worldwide profession, who might be seen to be 'statesmen' and to be acting in the public interest and in the interests of the long-run respectability of the profession. In 2001, the profession handed over responsibility for international standard-setting to the IASB, an independent body.

The IASB is supported by donations from large companies, audit firms and investor organizations. However, it took governmental backing from the EU and the SEC to bring IFRS into wide use.

CHAPTER 5

5.1

Question Distinguish between harmonization, standardization, convergence, adoption and EU endorsement.

Answer 'Harmonization' and 'standardization' have often been used interchangeably. However, standardization implies a narrowing down to one policy for any accounting topic, whereas harmonization implies that differences could be allowed to remain as long as the users of financial statements have a means of getting similar information from different statements.

In both cases, the '-ization' suffix tells us that there is a *process* towards a state rather than necessarily an achieved state. Both harmonization and standardization can refer to rules (de jure) or to practices (de facto). Chapter 4 discusses these issues.

'Convergence' is a more recent term, having much the same meaning as standardization. However, it is more elegant to say 'the convergence of two sets of standards' than 'the standardization of two sets of standards'. 'Convergence with IFRS' would normally mean gradually changing a set of domestic rules towards IFRS. However, in the context of US GAAP and IFRS, it means changing both so that the differences gradually disappear.

Adoption of IFRS means abandoning national rules as opposed to changing them. EU endorsement is the process of adopting IFRS, but not necessarily all of it.

5.2

Question Using the reconciliations of this chapter and the information in Chapter 2, comment on the adjustments that were necessary when moving from German or UK accounting to US or IFRS accounting.

Answer The reconciling items reveal the most important practical differences. These depend on the year in question, and of course on the GAAP that one starts from.

In the case of the UK and Germany, one major reconciling item is the absence of goodwill amortization under US or IFRS rules. The adjustments for non-controlling (minority) interests were large. This is confusing because, at the time, German and IFRS rules about the presentation of non-controlling interests were the same (treat them as part of equity) and US and UK rules were the same (show them outside equity).

When moving from UK or German rules to US GAAP (or to IFRS from 2009) interest on construction projects is capitalized rather than expensed, so equity rises. Also, under UK or German rules, financial assets were generally held at cost or lower, whereas many of them are marked to market (held at market value with gains and losses taken to profit and loss) under US GAAP or IFRS.

These and the other differences are explained by the companies in the notes attached to the reconciliations (see the companies' annual reports on their websites).

CHAPTER 6

6.1

Question Explain the purposes and uses of a conceptual framework.

Answer The main purpose of a conceptual framework is to guide the standard-setters when setting accounting standards. It may be useful because it limits the scope for disagreement and that for political interference. This is achieved by establishing the definitions of terms (such as 'asset') and the purposes of financial reporting. If all standards can be made to comply with the framework, then they are more likely to fit together coherently. Nevertheless, certain features of the existing frameworks are vague, so disagreements can continue even among adherents to them. Naturally, sometimes the standard-setters question or amend parts of their own frameworks, and sometimes they override the frameworks for political or other reasons.

Another purpose of frameworks is to enable preparers of financial statements to interpret standards, to choose from among options in them, and to establish accounting policies in the absence of standards. The auditors and interpreters of statements may also benefit from understanding this context.

6.2

Question 'Neutrality is about freedom from bias. Prudence is a bias. It is not possible to embrace both conventions in one coherent framework.' Discuss.

Answer There certainly would be a problem for neutrality if prudence were an overriding concept, as it seems to be in the EU's Fourth Directive. From 1989 to 2010, prudence was discussed in the IASC/B's Framework as 'a degree of caution in the exercise of judgements . . . under conditions of uncertainty' (paragraph 37). It was constrained in various ways. Certainly, much of the content of IFRS could be seen as lacking in prudence (e.g. taking gains on remeasuring investment properties, financial assets or biological assets before sale; or using the percentage-of-completion method for contracts). However, rules such as 'lower of cost and net realisable value' (of IAS 2) suggest prudence.

In the revision of the *Framework* in 2010, prudence was deleted on the grounds that it would compromise neutrality. However, the exposure draft of 2015 proposes to bring it back. Remarkably, prudence is said to be part of neutrality.

CHAPTER 7

7.1

Question To what extent are the reasons for different European accounting systems still relevant as reasons for different European IFRS practices?

Answer The suggestion from Chapter 2 is that the main reason for difference is different financing systems, with supplementary effects from tax systems, legal systems and external influence such as colonization. Some of the reasons could be summed up as cultural differences. These reasons might still exist, in reduced form, as motivations for different IFRS practice. If we confine ourselves to the consolidated statements of listed companies, there may be little difference in the main purpose of financial reporting across Europe. Nevertheless, listed companies in Germany or Italy may still be dominated by insider shareholders (e.g. government, banks and families), which might reduce their enthusiasm for the optional use of fair values or for extensive disclosures.

There is still scope for tax influence, if choices available for unconsolidated statements are tax-relevant and are also available under IFRS. This includes covert options, such as the identification and measurement of impairments. In such a case, the tax-driven unconsolidated choices might flow through to consolidated IFRS statements.

Different legal systems lead to different enforcement mechanisms and therefore to different degrees of compliance with IFRS.

7.2

Question Give examples of options allowed in IFRS and how they might be chosen differently in different countries.

Answer Assuming that the question refers to overt options, the easiest way to answer the first part of the question is to refer to Table 7.1. However, it would be worth noting that there are also covert options and measurement latitude in Tables 7.2 and 7.3.

The motivations for different choices are given in the answer to Question 7.1 above; to which might be added the inertia of carrying on with previous national practices. So, let us assume that the 'might be chosen' part of the question refers to examples of the choices rather than to examples of the method of choosing.

A simple example is the order of assets in a balance sheet: with inertia suggesting European increasing liquidity, but Australian declining liquidity. Similarly, inertia might suggest greater use of the option to revalue investment properties in the UK than in Belgium, Germany, Italy or Spain.

CHAPTER 8

8.1

Question 'US accounting is the best in the world.' Discuss.

Answer If good accounting is largely about disclosure, and more disclosure is better than less disclosure, then perhaps it is easy to agree with the quotation. An examination of full-scale US annual reports (including Form 10-K and other documentation) shows that the sheer volume of information is considerably greater than in any other jurisdiction. Analysts and academic proponents of the efficient markets hypothesis often argue that disclosure is more important than particular accounting rules.

However, it should be noted that these full-scale rules apply compulsorily only to SEC-registered corporations, although many other US corporations adopt some or all of these procedures. In terms of the proportion of companies publishing audited annual reports, the UK's regime is more extensive than that of most countries, despite recent increases in audit exemptions.

Another potential meaning of 'best' is 'leading'. Here, again, it is hard to deny that accounting developments have tended to start in the United States and then travel elsewhere, at least until the end of the twentieth century. This includes consolidation, lease accounting, segment reporting and many detailed accounting practices.

A potential criticism of US rules is that they are so numerous and detailed that accountants and auditors are left with no scope for judgement, and that the accounting is therefore sometimes wrong. This can be called a preference for 'rules-based' rather than 'principles-based' standards. For example, the detailed technical definition of a subsidiary allowed Enron to hide liabilities in thousands of unconsolidated but controlled entities.

One other concern about US accounting is its traditional opposition to current value information and to the capitalization of certain intangibles (e.g. development expenditure). This may deprive the user of financial statements of helpful information. However, changes to US rules (e.g. SFAS 115) required the use of current values for certain investments, and this started a trend.

It should be noted that certain other features of US accounting could be criticized (e.g. the permission to use LIFO).

8.2

Question To what extent, if at all, is US GAAP influenced by accounting in other countries?

Answer Clearly, just as the origins of the US language and legal system are British, so are the origins of the US accounting system. This was a strong influence. However, for most of the twentieth century, the United States saw itself as a leader rather than a follower, and so influences from abroad may have been slight. Also, the United States has generally had an enormously larger population of academic accountants than other countries. This has provided both ideas and criticisms.

In the last few years, the SEC and the FASB have acknowledged the importance of international differences in accounting. The contacts between the FASB and the IASC/B and other national standard-setters have grown greatly. The SEC has shown an interest in overseas companies, and has done its part in IOSCO to bring some backing for the IASC/B.

In 1997 major liaison between the IASC and the FASB led to changes, on both sides, to standards on earnings per share and segmental reporting. From 2001, it is clear that the FASB and the IASB have been trying to move together on projects. This was given formal agreement by the two boards in 2002. Several standards have been issued by the FASB to adopt aspects of IFRS, the first in 2005. Since then, the IASB's influence on the FASB has been major. In 2011, several major joint IASB/FASB projects led to changes to US GAAP. Even after the SEC made clear in 2012 that it was not adopting IFRS, some joint work continues, which influences US GAAP.

CHAPTER 9

9.1

Question 'Secret reserves make a company stronger, so they should be encouraged.' Discuss.

Answer Secret reserves can be achieved in various ways, such as by deliberately not recognizing assets or by undervaluing them, or by setting up unnecessary provisions. All these activities make the balance sheet look worse, and therefore there are hidden reserves. Of course, on the subject of provisions, which ones are necessary is a controversial issue. According to IAS 37, provisions should only be set up when there is already an obligation to a third party.

The creation of hidden reserves may make the company stronger by reducing the amount of dividends paid, because profits look lower. In the case of banks, building up a reputation for secret reserves may protect a bank from speculative pressures in times of economic difficulty. However, perhaps it would be even better protected by disclosing its strength (assuming that it actually is strong).

The main problem with secret reserves, from a financial reporting point of view, is that their existence seems to reduce the chance that the financial statements will give a fair presentation. How can anything hidden give a fair view?

9.2

Question Under IAS 32, some shares are treated as liabilities and some apparent liabilities are treated as partly equity. Is this a good idea?

Answer This question concerns fairness of presentation. Once a definition of a liability has been promulgated, it seems appropriate for accounting practice to be made to fit this. Otherwise, the readers of financial statements will find that some items shown as liabilities fit the established definition and some do not.

In the case of certain types of shares (e.g. redeemable preference shares), they fit the IASB's definition of liability because they involve an obligation to pay amounts from the issuer to the holder of the shares. The issuing company has deliberately chosen this type of share rather than ordinary shares because of the different legal features. So, it makes sense to account for them differently.

The treatment of hybrid securities is more complicated. It could be argued that an issuer must decide whether such a security contains any obligations and, if so, account for the whole of it as a liability. However, IAS 32 requires the issuer to treat such securities as partly shares and partly liabilities. An investment bank would be able to split a convertible debenture into these two parts, and could easily put a value on them. So, the IAS 32 treatment is practicable and perhaps leads to fuller information.

CHAPTER 10

10.1

Question Explain the various motivations of those who politically lobby standard-setters.

Answer The answer depends on which country we are talking about. In a tax-dominated setting (e.g. the rules for unconsolidated accounting in Germany), lobbying might concern an attempt to reduce earnings in order to reduce tax bills. Earnings reduction may also be relevant for regulated industries in any country. However, most of Chapter 10 is set in the context of the consolidated statements of listed companies in major capital markets. Here, the lobbying mostly concerns trying to increase or to stabilize earnings. There might also be lobbying against any proposed standards that would make liabilities look larger or that would require disclosure of sensitive information. This is connected to management's perceptions of the effects of such things on share prices, remuneration and reputation.

10.2

Question Give examples of political lobbying of US standard-setters, explaining in what ways the lobbying went beyond arguments about the correct technical solutions.

Answer The chapter lists examples in Sections 10.3.1, 10.4, 10.6.1 and 10.7. The meaning of 'correct technical solutions' needs to be discussed. This might mean accounting standards that are consistent with the conceptual framework and that lead to relevant and faithful information, subject to a cost/benefit constraint.

One clue that lobbying is going beyond technical issues is that reference is made to the supposed economic consequences of a standard or proposed standard. On this matter, the several stages of the debates on the Investment Tax Credit and Employee Stock Options are interesting.

Another clue to the existence of political lobbying is that different groups of companies lobby in different ways, predictably on the basis of how they are affected. Inflation Accounting and Petroleum Exploration Costs are examples here.

CHAPTER 11

11.1

Question 'Unlike US accounting, Japanese accounting is not a product of its environment but of outside influences.' Discuss.

Answer The answer needs to address whether US accounting is solely a product of its environment and whether Japanese accounting is solely a product of outside influences. Of course, the quotation contains a grotesque exaggeration, but is there anything in it?

The US part of the question can be answered with the help of the answer to Question 8.2 above.

Turning to Japan, it is clear that there has been much outside influence. The regulatory framework of the Companies Act is closely based on nineteenth-century Western European Commercial Codes. This involves, also, a dominance of tax considerations and a traditional lack of interest in disclosures or consolidation.

Overlaid on this is US influence after the Second World War in the setting up of Securities Laws, which particularly relate to corporations with publicly traded securities.

The textbook chapter describes many German and US features of Japanese accounting. Nevertheless, the particular mix of Japanese rules was unique to Japan, and it had its own interesting variations on goodwill write-offs, currency translation and post-retirement benefits. However, in the 1990s, Japan seems to have become more interested in international acceptability of its accounting output, and the IASC became more influential. By 2001, many of the Japanese differences from US or IFRS accounting had been removed. Since then, a formal convergence process between the IASB and the Japanese ASB has been in progress, and few major differences remain.

11.2

Question Which factors could have been used at the beginning of the 1990s to predict the direction in which Chinese accounting would develop?

Answer By the beginning of the 1990s, the Chinese economic reforms were already well under way. 'Capitalist' development areas had been created, and plans for stock markets were well advanced. Another easily predictable change was the return of Hong Kong to Chinese control in 1997.

Also, it has always been clear that the Chinese are good at operating markets, wherever they are allowed to do so around the world. All these factors suggest the emergence of a powerful quasi-market economy containing major stock markets. This suggests the sort of accounting suitable for such economies, i.e. Anglo-American accounting.

Since US President Nixon's rapprochement with China in the 1970s, American influence has grown, and British influence has always been strong, through Hong Kong. Perhaps one could have foreseen that the Chinese government would accept assistance from large audit firms when reforming accounting. Hong Kong's adoption of International Accounting Standards (in place of British standards) in 1993 was a typically canny move, which also might have been foreseen. This eased the way for acceptance of IFRS in China for certain purposes in 1997, and then for more substantial convergence (for listed companies) from 2007.

CHAPTER 12

12.1

Question Using information from this chapter and earlier ones (e.g. Chapters 2, 3 and 5), give examples of accounting topics on which there are major differences between two national accounting systems or between a national system and IFRS.

Answer Particularly important topics that show up in reconciliations to IFRS include pensions, goodwill and deferred tax. In many cases, most of the deferred tax difference is caused by the other adjustments. That is, for example, if a pension liability is increased, then a deferred tax asset is created to go with it.

The pension issue is complicated. It has been looked at in Chapters 6 and 9. Normally an adjustment from German accounting to US or IFRS would require an increase in pension expense and liability. BASF (see Table 5.9) is unusual in showing the reverse, because it had a pension fund that is not shown in its HGB consolidation. The fund was in surplus, so it improved the look of the financial statements when consolidated (as explained in the notes to the reconciliation in its annual report).

The goodwill adjustment is simpler to explain. Under German or UK national rules, goodwill was generally amortized. However, under US or IFRS rules, goodwill is not amortized but annually tested for impairment. This removes a large expense but, in bad years, might create an even larger impairment expense.

12.2

Question Are the arguments for differential reporting convincing? Should differentiation be made on the basis of company size or using some other characteristic?

Answer The key issue is whether the purpose of financial reporting is different for different types of company, and whether any different purpose requires different accounting. The size of a company, in itself, does not seem to be a particularly relevant issue, although size might be associated with something else, e.g. being listed or not. Of course, a very large unlisted company might have more stakeholders (e.g. more employees) than a small one.

The listed/unlisted distinction is the obvious candidate for differentiation. It is relatively easy to define, although even the exact definition of 'listed' can be a matter of debate. Listed companies have more 'outsider' owners (see Chapter 2), so there is a greater need for published information. If a company is not listed, perhaps the users of information (e.g. banks) can be relied upon to demand the information they need, so that no publication or audit rules are necessary for such companies, as in the US. Also, unlisted companies tend to be smaller, so perhaps should be relieved of the cost of publication, or at least of some of it.

The issue of whether unlisted companies should be allowed simpler recognition/measurement rules is contentious. It is unclear, for example, that lenders really need different information from that needed by shareholders.

CHAPTER 13

13.1

Question Is it both *desirable* and *possible* to harmonize company financial reporting in the European Union?

Answer The desirability of harmonization should be related to the beneficiaries: shareholders, lenders, companies and others. The European Union's aim of freedom of movement of capital is relevant. However, harmonization brings costly changes. It is arguable that harmonization is only really cost-effective for multinational enterprises. One should also ask whether perhaps accounting ought to remain different in different countries for various national reasons. The

costs and benefits differ for large/small companies, for listed/unlisted companies and for consolidated/unconsolidated statements.

The possibility of harmonization needs to distinguish between (i) the consolidated statements of listed companies, and (ii) other types of financial reporting. For (i), a large degree of harmonization has been achieved through the EU Regulation of 2002 requiring IFRS. For point (ii), discussion could proceed under the headings of (a) the process of Directives, etc., and (b) the progress so far in de facto harmonization. These issues are examined in the chapter.

It should be noted that it is not only the EU institutions that are helping with harmonization in the EU. The IASC had some effects in the European Union and capital market pressures led many European companies away from traditional practices. As noted, the EU Regulation on the use of IFRS has greatly increased harmonization for the consolidated statements of EU listed companies, but there may still be somewhat different national interpretations of IFRS.

13.2

Question In what ways have pre-communist and communist accounting affected post-communist accounting in Central and Eastern Europe?

Answer Post-communist accounting in Central and Eastern Europe was affected by pre-communist accounting in that there was a widespread reintroduction of pre-war German-based corporate law and commercial codes, which are, *inter alia*, seen as compatible with EU Directives.

One effect of communist accounting was that the low status of accounting in a command economy meant that accountants acted mainly as bookkeepers processing routine transactions, so that both advanced accounting (e.g. consolidations) and a sophisticated accountancy and auditing profession have had to be built up almost from scratch. The profession therefore had difficulty in acting as a source of improved practices and regulations which has meant that Ministries of Finance had to play a dominant role.

CHAPTER 14

14.1

Question The US, UK, France and Germany have evolved different answers to the question as to which business enterprises should be subject to accounting regulation. Which country, in your opinion, has got it 'right'?

Answer It is unlikely that there is one 'right' answer that fits all countries in all political and economic circumstances. Subjecting all businesses to accounting regulation (as in France and Germany) implies an interventionist state seeking control of accounting records for taxation and insolvency purposes and also desirous of protecting all stakeholders. However, sufficient resources may not be available for this to work in practice. At the other extreme (as in the US), a non-interventionist state may wish only to protect the investors in publicly traded enterprises. This ignores the interests of other stakeholders but can be achieved within the resources likely to be available. The UK has followed a middle course, attempting to protect all stakeholders (but especially shareholders and creditors) for all companies (but not partnerships and sole traders). In practice, enforcement has been weak for non-listed companies, partly through lack of resources.

14.2

Question In the UK, different types of individual company have different accounting rules. Why is the distinction between types of company not based solely on whether the company is public or private?

Answer The distinction between public and private companies was originally introduced in the early twentieth century to enable the Companies Act to include stricter disclosure rules for

companies with the right to issue shares to the public without imposing them on all companies. It must be remembered that the UK legal term 'public limited company' includes many companies that are not listed. Most private companies were small and not part of groups but some were not. Exempt private companies were invented in 1948 to distinguish family companies from the subsidiaries of public companies. Implementation of the Fourth Directive brought in the German innovation of distinguishing companies by size as measured by sales, balance sheet total and number of employees. These measures are relevant for all stakeholders, not just shareholders. UK rules in law now typically assume that all public companies are large and grant exemptions to small companies below sizes that vary according to the particular regulation. The possibility of sending shareholders summary instead of full financial statements is limited to listed companies. It appears that the UK legislator is pragmatic, using whatever distinction is available and suitable for a particular purpose.

The EU's Regulation on IFRS related to listed companies but this only imposes rules for consolidated statements, whereas the question relates to 'individual companies'. However, the IASB's IFRS for SMEs also largely uses the listed/unlisted distinction. This formed the basis of the new UK GAAP which came into force in 2015.

The ASB's FRSSE is available on the basis of size criteria: the same ones used in the Companies Act (i.e. only available to private companies). There are cost–benefit considerations at work here. Full-scale standards are expensive to implement, and might be especially burdensome for very small companies, who anyway might have few stakeholders.

CHAPTER 15

15.1

Question 'US accounting is better than accounting under German national rules.' Discuss.

Answer The question needs to address: 'better' for what purpose? Certainly, for the information of investors who wish to make financial decisions, US accounting does seem to be better, not least because there is more disclosure. Of course, US accounting is very expensive to operate, requiring regulators, standard-setters, auditors, massive annual reports, quarterly reporting, etc. This might be an unnecessary luxury for a country such as Germany which has relatively small capital markets. Consequently, US accounting might be worse for Germany. In particular, if the main purposes of German financial reporting are to calculate a conservative distributable profit and to calculate taxable profit, it seems appropriate to tie accounting to the tax rules. In the United States, tax calculations have to be done separately from financial reporting which adds another layer of expense.

US financial reporting produces a much more volatile series of earnings figures than German accounting does. This may suit users related to active stock markets but may not suit a longer-term view, which is traditionally associated with German financiers and managers.

Beginning in the late 1990s, it was normal practice for large listed companies in Germany to use US or IFRS accounting for their consolidated statements. IFRS is required from 2005, although groups that were already using US GAAP were allowed to continue this until 2007. So, now, IFRS is used for one purpose in Germany, and HGB accounting for another.

15.2

Question Discuss the advantages and disadvantages, for a country such as Germany, that would follow from requiring or permitting companies to apply IFRS in their individual financial statements.

Answer Supporters of retaining the HGB and not moving to IFRS argue that individual statements are mainly prepared for the determination of tax liabilities and distributable income, not to give information to capital markets. Existing German rules are thought to be better suited for tax and distribution purposes than are IFRS, and the changeover could lead to higher tax bills. In

reply it can be argued that commercial figures could be used as the starting point for tax calculations and that adjustments could be made outside the accounting records as in the UK. There is no reason for total corporate taxation to go up, although its incidence might change. To some extent, this separation began from 2010 as the Bilanzrechtsmodernisierungsgesetz came into force.

A further argument against adopting IFRS is that Germany would lose control of accounting standard-setting, handing it over not to an EU institution but to an unelected private-sector body dominated by Anglo-Saxon accountants. This may be an acceptable price to pay for German multinationals requiring access to international capital markets but there is no need to accept it for the great mass of German business enterprises.

It will be difficult for two diverse sets of rules to exist side-by-side and there will be pressures to harmonize them. Given that Germany finds it difficult to influence IFRS, local rules are likely over time to move towards IFRS (albeit more slowly than in the UK) rather than IFRS to move towards German rules.

CHAPTER 16

16.1

Question Discuss different possible interpretations of the concept of a group, and how these may relate to different styles of corporate governance and company financing.

Answer The parent concept of a group is based on legal control, which in turn relies on majority voting rights and shareholdings. In some countries, control can also be achieved by contract. The entity concept has the advantage that it does not treat non-controlling shareholders differently from controlling shareholders; rather, it attempts to look at all enterprises in the group as part of the same economic entity. It also appears to have advantages for user groups other than shareholders, such as employees. The proprietary concept can, more easily than the previous two, accommodate cases where an enterprise's membership of a group is less clear-cut, for example, where an enterprise only partly belongs to a group or belongs to more than one group (i.e. where neither a parent nor legal dominance can be identified). Here, ownership and the right to exercise 'significant influence' are decisive factors.

The reason that different concepts of a group have arisen, and appear to 'fit' the patterns in some countries better than in others, can be linked to historical economic developments and patterns in corporate financing. For example, the economic climate in the US at the turn of the twentieth century encouraged commercial activity and expansion; as a result companies were formed and began to carry out their activities in groups. Holding companies were established earlier than elsewhere. While groups or networks of companies were also established early in, for example, Japan or continental European countries such as Germany, the different form of company financing and corporate governance (including supervisory boards) encouraged the growth of informal networks of companies and providers of finance such as banks, with cross-shareholdings (and 'cross-directorships' on each other's supervisory boards where these existed).

16.2

Question 'The EU Seventh Directive was a much more useful harmonizing tool than the Fourth Directive was.' Discuss.

Answer From an Anglo-Saxon viewpoint, it can certainly be argued that the publication of consolidated statements by many European companies that did not previously publish them transformed financial reporting practice. Note, however, that the Seventh Directive could not have been adopted if the Fourth was not already in place, and that capital market pressures were already pushing large European multinationals towards consolidation.

The Fourth Directive, it could be argued, established as law some not very useful formats and some permissive measurement rules which would better have been left to accounting standard-setters.

The Seventh Directive perhaps achieved more harmonization of concepts and techniques than the Fourth Directive did. Major issues either were not covered in the Fourth Directive (e.g. leasing and long-term contracts) or were then handled as options (e.g. valuation of assets). The Seventh Directive contains clear rules on several issues, e.g. equity accounting, some elements of the goodwill calculation and the definition of a subsidiary. Of course, there are still options (e.g. the treatment of goodwill, and the use of proportional consolidation).

For listed companies, the Seventh Directive has now been overtaken by the EU's Regulation on IFRS of 2002.

CHAPTER 17

17.1

Question Why was there so much controversy over currency translation methods for group accounting? Which method do you prefer?

Answer Controversy in accounting standards generally seems to arise between preparers (company management) and the standard-setters. Only in extreme cases do the government, the press or user groups become seriously involved. Academics can usually be relied upon to provide arguments, but generally on at least two sides. Controversy from management relates to extra disclosures, extra costs or a change to values or profit measures. In this case, most of the argument seems to relate to profit measurement. It is particularly in the United States that the controversy has been greatest. This is because most other countries fall into two categories: those where consolidation of overseas subsidiaries was traditionally unimportant and where taxation is an important influence in accounting so that group accounts were of little interest (e.g. Japan, Germany); and those who generally followed US practice (e.g. Canada, and many other countries to a lesser extent). In the United States, the problem seems to be that standard-setters have tried to establish theoretically coherent practice. By contrast, the United Kingdom standard-setters steered clear of the subject until the 1980s and then allowed current practice to continue, with a variety of options.

The history of US statements on currency translation is lengthy and is examined in the text. SFAS 8 of 1975 established the theoretically neat model of the temporal principle, which can be called the temporal method when applied to historical cost accounting. This method relates the choice of translation rate for any item or balance to the timing of its valuation basis. This results in assets being valued at historical cost both before and after translation (i.e. in both the subsidiary's and the parent's currency). By contrast, the current rate method causes translated assets of subsidiaries with depreciating currencies to disappear gradually.

The problem with the temporal method is that it generates losses (in the group income statement) when the parent's currency is weak. Consequently, the temporal method led to greater volatility of profits, and in particular to losses when the dollar was weak in the late 1970s. These losses occur even if the subsidiary has matched overseas loans with overseas assets. This difficulty led to massive complaints from management, followed by a move to the current rate method in SFAS 52. Because it is particularly obvious that the current rate method gives ridiculous results when there are large exchange rate movements, the temporal method is still to be used for subsidiaries in highly inflationary countries (100 per cent or more, cumulatively, in three years).

The fundamental problem is that exchange rate movements are linked to price changes. While accounting generally ignores the latter, any recognition of the former creates insuperable measurement difficulties.

There are several further arguments in favour of the current rate method to be found in various UK or US exposure drafts and standards. These are dealt with in the chapter, and most of them seem to be 'excuses'.

In terms of quality of information for users of financial statements, the temporal method without gains and losses going to income might be the best. This was used by some German multinationals. Otherwise, it is a question of which faults are least worrying. Of course, if current value accounting were used, most of the problems of currency translation would go away.

Incidentally, this answer has been written on the assumption that the question concerns the translation of the financial statements of foreign subsidiaries. The other issue would be the translation of transactions or balances in foreign currency in an individual company's financial statements, which are carried through to group accounts. There is some controversy here, particularly concerning whether unsettled gains can be taken in income.

17.2

Question Why has it been difficult, particularly in the United States, to create a satisfactory accounting standard on foreign currency translation?

Answer Some elements of the answer to this question can be extracted from the answer to Question 17.1 above.

The United States seems to have originally looked for theoretical coherence, but this is a hopeless task in the context of historical cost accounting. If one ignores price changes but tries to adjust for exchange rate changes, the arithmetic will not work because the former help to cause the latter.

The United Kingdom seems to have adopted simple and pragmatic approaches.

France and Germany have been relaxed about the issue because relatively few companies are concerned and there are no tax effects. The Seventh Directive steered clear of this issue because it was controversial (for example, the UK liked the closing rate method and the Germans liked the temporal method) and because several countries were happy with silence on the subject (including the United Kingdom).

CHAPTER 18

18.1

Question Explain why standard-setters have difficulty in drafting segment reporting standards.

Answer Standard-setters in the United Kingdom had difficulty with the arguments concerning the invasion of privacy and damage from competitors (see the answer to Question 18.2). In other words, there are questions relating to exemptions. For example, if 'small' companies are to be exempted, how does one define small? In the United States, this was not a problem, because FASB rules are only enforced on SEC-registered companies.

More generally, there are difficulties in defining what is meant by a segment. Too many segments would make the data unwieldy. Too few would risk losing valuable data. Also, how does one force companies to provide useful segments rather than superficially plausible ones? For example, on grounds of risk and growth, it might be useful to include Germany and Japan together, but it is very tempting for companies to include Germany with Albania (Europe) and Japan with Cambodia (Asia).

Further difficulties relate to whether sales should be segmented by producer or customer; whether profit should be net of extraordinary items and whether assets should be shown net of liabilities.

18.2

Question How could one demonstrate that the benefits of segment reporting outweigh the costs?

Answer The headings of benefits and costs are fairly easy to establish, but to measure some of the items is difficult.

The benefits are discussed in Section 18.4. Of course, although the initial impact is to assist analysts, the benefits should flow to the companies that provide good segmental data because these will improve the market's confidence in such companies. Researchers on the benefits of segment reporting have looked at whether: users want it; users use it; forecasts improve predictions; and share prices react to it.

The costs might accrue under two main headings:

1 *Preparation, audit and publication*. However, most standards allow companies to use their own structures to determine segments. In this case, preparation costs seem unlikely to be large for data that management should already be using. There would be some audit and publication expenses but not more than attached to other notes of similar length. It might be possible to measure these costs.

2 *Invasion of privacy, damage from competitors*. This seems a weak argument. Segments can be so large that segment reporting is unlikely to give surprising information to alert competitors. The US and IASB rules apply only to companies with publicly traded securities. The *IFRS for SMEs* does not cover segment reporting, in order to reduce costs for unlisted companies.

CHAPTER 19

19.1

Question Why is it necessary to have international auditing standards?

Answer This question can be answered in two stages: (a) why has auditing become international? and (b) why are standards necessary?

As explained in the text, auditing has been internationalized because of the emergence of MNEs, and because of the demand for international auditing from international capital markets. International auditing standards have arisen because it is in the interest of MNEs and, especially, of international auditing firms to have no differences in auditing requirements between countries. It is also in the interests of those who interpret the financial reports of multinational groups.

19.2

Question Would it be better if international auditing standards were set by the United Nations rather than under the existing system?

Answer Under the present system, international auditing standards (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB), a private-sector body composed of professional accountants. This ensures the technical quality of the ISAs since they are drawn up by experts. On the other hand, the IAASB may be working in the self-interest of international accounting firms, which is not necessarily the general interest, and it has no means of ensuring compliance with its standards. The case for the UN to set ISAs rests on the argument that it would better represent the public interest. It is not clear, however, who the public is. It may be composed partly of the host countries of MNEs, but the primary stakeholders are the shareholders of the MNEs, who may prefer the existing IAASB. The UN probably does not possess sufficient international auditing experts but could buy them in. Unlike national governments,

the UN possesses no power to enforce auditing standards. However, many UN member states, especially within the EU, have set up audit supervisory bodies which seek, inter alia, to enforce national auditing standards which closely follow ISAs.

CHAPTER 20

20.1

Question To what extent is the making of rules on financial reporting in the US separated from their enforcement? What is the historical background to the present situation?

Answer Both the making and the enforcement of financial reporting rules for publicly traded companies in the US are the responsibility of the SEC, set up as a federal agency in the early 1930s as a result of the stock market crash of 1929. From the start, the SEC has exercised a strict enforcement role but has preferred to supervise standard-setting by an authorized private-sector body (currently the Financial Accounting Standards Board) rather than making the rules itself. This strategy has the advantages of leaving the technical details to the experts and shielding the SEC from criticism. As the standards will be enforced, there is extensive lobbying, but it is usually the FASB that is lobbied rather than the SEC. Now that IFRSs are accepted in the US (for foreign registrants), the SEC enforces them more literally than is the case in other countries.

20.2

Question What are the arguments for and against proactive surveillance by enforcement bodies?

Answer Proactive surveillance requires an organizational set-up and budget which may not be initially available to an enforcement body. Further, resources may be used in investigating companies unlikely to be breaching the rules. On the other hand, awareness that all listed companies may be investigated may deter companies from transgressing and may strengthen the hands of their auditors. All enforcement bodies are, at least, reactive but solely reactive surveillance may result in ‘shutting the stable door after the horse has bolted’.

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