CHAPTER 2

Causes and examples of international differences

Outline Answers to Questions

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

[See Appendix in textbook.]

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

[See Appendix in textbook.]

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?

Most African countries were under the control of colonial powers for much of the twentieth century. Therefore, it is likely that the best predictor of accounting regulations or practices is that such countries will have an old version of those of the colonial power. Furthermore, the African country is likely to have inherited its style of legal system and accounting profession, which will reinforce the style of accounting.

For example, one would expect a French influence on an African country to extend to the use of an accounting plan, whereas British influence would lead to the use of 'standards', perhaps based on British or IASB rules. See the paper by Elad (2015), referred to in the chapter.

The size of equity market might not be a good predictor for these countries. Some former British colonies may have had no substantial equity market but might have accounting rules suited
to one.

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

The basic thesis is as follows:

1. In all countries, the government will be interested in the calculation of profit in order to calculate taxable income and prudently distributable profit.

2. Financial reporting rules in a country tend to be driven by large companies because they exercise the greatest influence over the rule makers.

3. In countries with large numbers of listed companies that have large numbers of non-director shareholders, there will be a demand for large quantities of published, audited financial information used for making financial decisions.

4. In these countries, the government's accounting/tax rules will be unsuitable for financial reporting, so accounting calculations will have to be done twice.

5. In other countries, a few large 'international' companies may volunteer to use non-tax rules for group accounts.

If, for example, the United Kingdom and the United States are countries as described in point 3, whereas Germany and Italy are not, the financial reporting will differ.

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?

Using the answer to Question 2.4 (above), the conclusion would be that a basic split of countries into two groups is not caused by tax differences. The fact that some countries have financial reporting closely linked to tax is not caused by differences in the calculation of taxable income.

However, at the next classification level down, we might be looking at a series of countries in all of which the tax rules and the financial reporting rules are closely linked. In that case, differences in tax rules would be likely to cause differences in financial reporting. For example, if tax rules allow the use of last-in first-out (LIFO) (as in Germany, Japan or Italy), financial reporting in those countries may be affected by companies choosing that practice.

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.

Although a probable relationship between possible causal factors and their effects can be established, it is not possible to be certain that these factors have caused specific differences, or to what extent they may have done so. This is due to the fact that some variables, for example culture, are not easily measurable. Attempts, such as the one by Hofstede, to quantify such an intangible factor and to measure its impact, could only provide partial explanations (this is accepted by Hofstede). Further, other researchers' different definitions of culture and research designs have come up with somewhat different results. Additionally, cultural data are usually collected for anthropological or sociological research, rather than specifically for research related to accounting; and problems can arise if data are used for purposes other than those for which it was originally collected.

Perhaps the greatest problem in linking causal factors to effects lies in the fact that most variables are not independent of each other. For example, it is difficult to separate the effects of culture and language or of company financing and the influence and size of the profession. Also, many factors can represent both cause and effect. For example, taxation regulations are the cause of some of the differences in accounting measurement regulations, while at the same time the extent of the link between financial reporting and taxation represents one of the major differences between countries. Finally, the influences of the causal factors on accounting are not static, but their relative importance changes with time. Historical, economic or political events can introduce new factors or change their effect.

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

There is clearly a link between corporate governance structures and the ownership structures of companies (see also the answer to Question 2.4). According to Zysman's classification, companies in some countries (such as the United Kingdom or the United States) rely on financing through capital markets and individual shareholders, while in other countries they depend on finance from governments (e.g. France and Japan) or from financial institutions (e.g. Germany). The respective corporate governance systems are in place to help with the governance of the companies on behalf of their stakeholders.

In many continental European countries, companies have a two-tier board structure consisting of an executive board of directors and a supervisory board. The (non-executive) directors on this supervisory board represent various groups of stakeholders, most notably the providers of finance (e.g. banks and major shareholders) and employees. This means that there is a reduced requirement for the publication and auditing of objective/fair information, since interested parties will have access to this information in their position as 'insiders'. At the same time, it is in the interest of these stakeholders to emphasize the protection of creditors and the long-term survival of the company (as opposed to short-term profits), in other words, to favour conservative accounting rules. In countries (such as the United Kingdom) where companies have only a single (executive) board of directors and where stakeholders are much more dispersed and external to the company, there is a greater requirement for audited, fair information and disclosure.

Another link exists between legal systems and the degree of government control as opposed to private sector regulation. For example, the two-tier board structure and the functions of each board are specified in detail in German legislation, while the United Kingdom prefers private sector regulation.

Note, however, that the differences described here are becoming less distinct. In the United Kingdom, for example, changes to corporate governance structures led to the appointment of non-executive directors and audit committees for large listed companies, while, in Germany, the desire of large multinational companies to raise finance on international capital markets has led to a move away from credit/insider financing and towards 'fairer' reporting rules.

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

In principle, international differences in the shape of balance sheets should not be a major obstacle for international comparisons. Users of balance sheets can easily rearrange them to a preferred format. The most obvious difference is that, in some countries (e.g. the United States), balance sheets start with cash, whereas in other countries (e.g. in Europe), they start with intangible assets and move down in the order of increasing liquidity. Some balance sheets do not contain a current/non-current distinction, although equivalent information can usually be found in the notes. A more subtle difference is that some balance sheets combine all debits together (on the left or at the top), whereas others show the financial position by calculating net current assets and then net assets. This difference might mislead users by focusing attention on different totals.

A more serious problem is that there are two basic styles of profit and loss account: by nature and by function. The 'by nature' format shows total wages, total depreciation and so on. For a manufacturing industry, this means that cost of sales and gross profit are not shown. This format is production oriented and is used in France, Germany, Italy and Spain (although many large German companies use the other style). The 'by function' format combines expenses together by stage of production: manufacturing expenses, administration expenses, distribution expenses and so on. It therefore shows the calculation of gross profit. This is generally used in the United States and the United Kingdom.

There may be enough information in the notes to a 'by function' format to enable the calculation of the 'by nature' figures, but the reverse is seldom the case. This is a problem for analysts in Anglo-Saxon equity markets who are trying to interpret continental European statements.

CHAPTER 3

International classification of financial reporting

Outline Answers to Questions

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.

[See Appendix in textbook.]

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.

[See Appendix in textbook.]

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?

'Culture' is a large word. In a sense, culture could be said to be the cause of international accounting differences, if the word includes legal systems or capital markets. Taking a narrower meaning, it might then be that such features as 'conservatism', 'individuality' or 'respect for authority' are relevant as partial explanations of accounting differences. Of course, these features and the legal/capital/other institutional features and the accounting systems interact. Consequently, to some extent, each one causes the others.

Gray (1988) proposes a relationship between the cultural factors and accounting, and he uses Hofstede's (1980) statistical analysis as a basis for a model. Gray suggests that measurement/disclosure issues might usefully be separated from enforcement issues. However, the subsequent research to connect the cultural values to the real accounting systems has not been very successful. In principle, cultural differences would seem to be important in the preparation of a hypothesis for a classification, or they could be used to check the reasonableness of existing classifications.

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

One measure of 'success' might be whether the classification is reasonable, that is, does the classification survive in the light of cultural and evolutionary considerations? For example, the Da Costa *et al.* (1978) classification that shows the United States and the United Kingdom as the least alike countries in the world seems not to survive this test of reasonableness.

Another indication of 'success' might be the clarity of the classification. Is it clear what is being classified and what the relationships between the members of the population are? A classification might be unsuccessful if it left out important members of the population or could not convincingly place a particular member in a unique location in the classification.

Of course, another indication of success would be if students, researchers or practitioners used the classification for various purposes. In academic terms, it might be successful if it was referred to frequently by other researchers.

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

Students have a range of classifications to consider in the chapter and its reading list. The reasoning for the choice might include the following issues:

(a) coverage of countries;

(b) plausibility in the light of culture, evolution, common sense;

(c) clarity of what is being classified;

(d) usefulness for learning or other purposes;

(e) existence of hierarchy, rather than unconnected groups and

(f) countries placed in unambiguous groups.

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

It would be possible to try to classify rule makers, rule enforcers, listed companies by disclosure practices, all companies by measurement practices and so on. Exactly what it is that one classifies should depend on the purpose of the classification and the availability of suitable data.

Another aspect of the question is whether one should classify on the basis of culture, institutional factors and environmental backgrounds. In this case, one would not be classifying 'accounting' but potential influences on accounting. Instead, one should presumably classify by measuring the characteristics of whatever it is that one is trying to classify. For example, an international classification of the accounting measurement practices of listed companies should presumably be based on differences in those practices. The other background factors can be used to propose a hypothesis for classification or to check the reasonableness of a classification.

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

The evidence from old classifications is ambiguous. Mueller (1967) puts the United Kingdom and the United States together; however, classifications based on Price Waterhouse data do not (see da Costa *et al.*, 1978; Frank, 1979; Nair and Frank, 1980). Nobes (1981) suggests that this may be caused by data problems. Nobes (1983) puts the United States and the United Kingdom together and Doupnik and Salter (1993) agree.

More recently, Alexander and Archer (2000) and D'Arcy (2001) cast more doubt on an Anglo-Saxon grouping but Nobes (2003 and 2004) tries to disprove their arguments.

The IASB can be seen as a proponent of capital-market-based accounting (or decision-usefulness accounting). Since this is set to dominate the world, at least for listed companies, perhaps the 'Anglo-Saxon' category has now become an inaccurate description.

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

The old classifications might be *less* relevant rather than irrelevant. They still show the historical position, assuming that they revealed some truth at the time. In some cases, the basic structure of the classification can still be used (e.g. Nobes, 1998 updates Nobes, 1983).

Certain countries (e.g. Sweden) have clearly moved to the left of Nobes' classifications over the decades. Other countries (e.g. China) had no 'financial reporting' before the 1990s but would now have to be included. Further adjustments need to be made for the fact that two systems of accounting (i.e. domestic and IFRS) are now found in many countries. In other words, it would be better to classify accounting systems rather than countries.

However, two new ways of classifying *countries* have recently emerged: by their reactions to IFRS (e.g. is IFRS banned, allowed or required for unconsolidated statements?), and by their IFRS practices (e.g. which options within IFRS are generally chosen?).