

Chapter 2

Development and Classification

Discussion Questions

1.
 - a. *Sources of finance.* Where capital markets/shareholders are the principal source of finance, accounting focuses on profitability, stewardship, and a fair presentation of results and financial position. There are high levels of disclosure in published financial statements. When banks are the principal source of finance, accounting tends to be conservative and disclosures are usually relatively low (banks have direct access to information). When governments are the principal source of finance, accounting is aimed at the information needs of government agencies such as tax collection, assembling macroeconomic statistics, or compliance with macroeconomic goals.
 - b. *Legal system.* Accounting in code law countries tends to be highly prescriptive, detailed, and procedural, designed to cover every possible circumstance. Accounting standards are a part of national laws. Accounting in common law countries is more adaptive and innovative and tends to allow more judgment to suit the circumstance. Accounting standards are set in the private sector.
 - c. *Taxation.* This tends to parallel the legal system. In common law countries (where accounting standards are set by the accounting profession), accounting and taxation are separate. In code law countries (where accounting standards are national laws), accounting and taxation are essentially the same.
 - d. *Political and economic ties.* Accounting technology and expertise is imported and exported based on the contacts that nations have with one another through commerce, conquest, and so on.
 - e. *Inflation.* Historical cost accounting is the basis for initially recording transactions around the world. Inflation puts stress on the historical cost principle. Where inflation is high, accounting adjusts recorded amounts to reflect price level changes.
 - f. *Level of economic development.* This factor defines the difficulty and types of accounting issues that are faced in a nation. Accounting is complex where business transactions are complex (in highly developed economies); it is simpler where transactions are simpler (in less developed countries).
 - g. *Education levels.* This factor defines the limits of accounting sophistication in a nation. Accounting cannot get very sophisticated where education levels are relatively low (unless the country imports accounting training or its citizens are sent elsewhere for it).
2. Culture underlies institutional and other arrangements in a nation that directly affect accounting development. Individualism, power distance, and uncertainty avoidance are likely to be the most important influences. Individualism, small power distance, and weak uncertainty avoidance tend to be correlated with and found in common law countries with fair presentation accounting. There is a strong accounting profession, accountants rely on professional judgment, and capital markets are the principal source of finance.

Collectivism, large power distance, and strong uncertainty avoidance tend to be correlated with and found in code law countries with legal compliance accounting. The profession is relatively weak—accounting is influenced by law, instead. Accounting is more conservative and prescriptive, and banks and governments are the principal sources of finance.

3. This question is controversial and there is no consensus of opinion at present. However, as noted in the answer to question 2, culture exerts a second-order effect on accounting. It underlies institutional and other arrangements in a nation that directly affect accounting development. We feel that economic and legal factors are more clearly linked to specific features of accounting, whereas cultural variables are linked to broader generalizations about accounting. Thus, we argue that economic and legal factors explain national differences in accounting practice better than culture.
4. Generally speaking, these patterns of accounting development are still valid today, but less so than in 1967. The descriptions of accounting in the chapter for the respective exemplar countries are broadly true. However, note that the Netherlands is really the only country that can be described by the microeconomic pattern. There are also only a few countries that follow the macroeconomic pattern. The independent discipline approach is not as ad hoc as it was in 1967. Most of these countries (in particular, the United Kingdom and United States) now have conceptual frameworks to guide accounting policy formulation. The uniform accounting approach is less relevant as more and more countries privatize their economies.

We expect these patterns to break down in the future as financial reporting converges around International Financial Reporting Standards. As discussed in this chapter, the trend is for fair presentation accounting at the consolidated financial statement level. The macroeconomic and the uniform approaches will persist in certain code law countries at the individual company financial statement level (for example, for tax collection purposes). The microeconomic and independent discipline approaches have always been fair presentation oriented. So, they will likely disappear due to convergence, as discussed above.

5. Conservative measurements and secretive disclosures tend to be correlated. At the same time, less emphasis on conservative measurements and transparent disclosures also tend to be correlated. This is largely due to the principal source of finance in a country. Banks and governments are concerned about the safety net that conservatism affords; and because they tend to have direct access to information, public disclosure is less important. Capital markets demand a fair presentation of financial position and results of operations along with high levels of disclosure
6. Classifications are a way of viewing the world. They abstract from complexity and reveal fundamental characteristics that members of the group have in common and that distinguish the various groups from one another. Classifications provide the basic structure for understanding what is alike and what is different in accounting around the world. By identifying similarities and differences, our understanding of accounting systems is improved.

Judgmental classifications rely on knowledge, intuition, and experience. Empirically derived classifications apply statistical methods to databases of accounting principles and practices around the world. This chapter discusses Mueller's four approaches in accounting development (1967), which is essentially a judgmental classification of accounting. The fair presentation versus legal compliance classification and classifications based on legal systems are also judgmental, though largely supported by empirical data.

7. The chapter discusses three major accounting classifications. The first is the one by Mueller (1967):
 - a. Macroeconomic approach, where accounting practice is designed to enhance macroeconomic goals;

- b. Microeconomic approach, where accounting develops from the principles of microeconomics;
- c. Independent discipline approach, where accounting develops from business practices based on judgment and trial-and-error; and
- d. Uniform approach, where accounting is standardized so it can be used as a tool of administrative control by central government.

The second classification is the one based on legal systems, which closely parallels the third classification based on practice systems. Generally speaking, the features of common law accounting (legal system) are those described for fair presentation accounting (practice system). The features of code law accounting (legal system) are those described for legal compliance accounting (practice system).

Fair presentation (common law) emphasizes substance over form and is oriented toward the decision needs of external investors. Thus, it is capital markets oriented. Financial statements help investors judge managerial performance and predict future cash flows and profitability. Extensive disclosures provide additional relevant information for these purposes

Legal compliance (code law) accounting is designed to satisfy government-imposed requirements such as calculating taxable income or complying with the national government's macroeconomic plan. The income amount may also be the basis for dividends paid to shareholders and bonuses paid to employees. Conservative measurements ensure that prudent amounts are distributed and smooth income brings stable tax, dividend, and bonus payouts.

As noted above, fair presentation accounting is associated with common law countries, whereas legal compliance accounting is associated with code law countries. However, many companies from code law countries now follow International Financial Reporting Standards in their consolidated financial statements. IFRS are based on the principles of fair presentation.

- 8. The chapter contends that many accounting distinctions at the national level are becoming blurred because of global capital market pressures. An increasing number of companies are listing on multiple stock exchanges. This has pressured accounting policy makers around the world to harmonize (converge) reporting requirements. This has also pressured companies to devise financial reporting practices that satisfy multiple requirements and user groups. At the same time, some code law countries where accounting is aimed at legal compliance have dual reporting. Consolidated financial statements are aimed at fair presentation (IFRS), whereas individual company financial statements continue to be aimed at legal compliance.
- 9. Our preference for classifying based on fair presentation versus legal compliance over legal system follows from the answer to question 8. Many companies from code law countries now prepare two sets of financial statements. Consolidated financial statements follow fair presentation principles, whereas individual company accounts follow legal compliance principles. Listed companies from the European Union now follow International Financial Reporting Standards in their consolidated financial statements. IFRS are based on fair presentation principles.
- 10. In your authors' opinion, the prospects for the harmonization of national systems of accounting is low. As the chapter demonstrates, accounting satisfies the information needs of its users and develops in response to environmental circumstances. Unless these forces

converge, there is little reason to expect accounting to converge. Also, taxation is a fundamental influence on accounting in many countries—it is the reason accounting exists in the first place. Unless governments are willing to relinquish their sovereignty over such matters, national accounting systems cannot be harmonized. At the national level, accounting systems are too entrenched.

However, the story is different at the transnational (or international) level for consolidated financial statements. Convergence is occurring here, driven by the globalization of capital markets. Companies now seek capital from around the world and must appeal to the information needs of a worldwide investor group. The type of information these investors seek is similar, regardless of where they reside. This same force drove the European Union requirement for listed companies to comply with International Financial Reporting Standards starting in 2005. This means dual reporting for many companies, especially those from European countries where accounting is legalistic and tax-driven. Local financial statements will be prepared in compliance with local laws and accounting standards, but secondary financial statements will be prepared for the worldwide investor group. Consolidated financial reporting is converging onto fair presentation based on IFRS.

Exercises

1.
 - a. The dominant factor influencing accounting development in Taiwan is political and economic ties, namely those with the United States since the 1950s. In 1949, defeated by the Communists, Chiang Kai-shek fled to Taiwan and set up a provisional government there. Taiwan soon began receiving substantial U.S. economic aid to prevent the further spread of Communism. Taiwan is a dynamic capitalist economy and the United States is the country's largest trading partner. Taiwan is an economic power that is a leading producer of high-technology goods. Services make up more than two-thirds of GDP. Nevertheless, small, family owned businesses are the basis for the economy. Taiwan has a credit-based, rather than capital markets-based financial system. Its (Germanic) code law legal system dates from the years (1895–1945) when Taiwan was a Japanese colony. Given the influence of the United States, it can be expected that taxation will not directly impact financial reporting (despite the code law legal system). Additional development factors are a low level of inflation and high education level (literacy rate approaching 100 percent).
 - b. Overall, one would expect accounting to resemble U.S. accounting, emphasizing a fair presentation and full disclosure as opposed to compliance with legal requirements. Accountants can be expected to exercise judgment and not merely follow the rules or the tax laws.
 - c. The above prediction is accurate according to the fifth edition of this textbook (Prentice Hall, 2005) and Ronald Ma, ed., *Financial Reporting in the Pacific Asia Region*, Singapore: World Scientific Publishing (1997). Accounting in Taiwan is largely based on U.S. accounting. Accounting standard-setting is a private sector activity, modeled after the U.S. Financial Accounting Standards Board.
2. Gambia and India (both former British colonies) have common law legal systems, whereas Belgium, Czech Republic, Mexico, Senegal (former French colony), and Taiwan have code law legal systems. China's legal system is not derived from code law, but more closely

resembles code law than common law. Gambia and India have fair presentation accounting because of the British colonial influence and Senegal has legal compliance accounting because of French colonial influence. As members of the European Union, both Belgium and the Czech Republic require International Financial Reporting Standards (fair presentation) for consolidated financial statements. China is also basing its reporting standards on IFRS. Because of U.S. influence, Mexico and Taiwan have fair presentation accounting.

3. At the time of writing, the 2008 annual report was the most recent one available. The stock exchanges with the most foreign listed companies were London (681), New York (415), Nasdaq (336), Singapore (312), and Mexico (248). The attraction of New York, London, and Nasdaq for foreign companies is that these are the major capital markets in the world. Singapore attracts many Asian companies, whereas Mexico attracts many Central and South American companies.

The stock exchanges with the highest proportion of foreign to total listed companies were Luxembourg (87 percent), Bermuda (69 percent), Mexico (66 percent), Singapore (41 percent), and London (22 percent)/Swiss (22 percent), [tied]. Luxembourg attracts many European companies. The Swiss Exchange does as well. London is an attraction not only for European companies but also for companies from countries of its former empire. Bermuda is known as a financial center with easy laws, which may explain its high proportion. As noted, The Mexican Exchange attracts companies from Central and South America.

4. Arguably the most serious obstacle to accounting harmonization in the EU is that common and code law countries are both represented. This determines how standards are set and the basic orientation of accounting. However, differences can be noted in every developmental factor discussed in the chapter, including the cultural dimension. Nevertheless, the economic and political ties among the member countries are a dominant force supporting EU harmonization—the group is committed to economic integration, including a single currency, the euro. EU countries are converging on fair presentation accounting for consolidated financial statements, propelled by market forces such as these.
5. For the ten countries joining the EU in 2004 and the two countries joining in 2007, the level of economic development and the fact that they lack developed capital markets (system of finance) is likely to be the most serious obstacles for achieving accounting harmonization with the rest of the EU. Most of these countries are still expanding their market economies from ones that were centrally planned. Accounting expertise is also still being developed.
6.
 - a. The individualism scores are: China (20), the Czech Republic (58), France (71), Germany (67), India (48), Japan (46), Mexico (30), the Netherlands (80), the United Kingdom (89), and the United States (91).
 - b. Countries with high individualism scores are France, Germany, the Netherlands, United Kingdom, and United States. Countries with medium individualism scores are Czech Republic, India, and Japan. Countries with low individualism scores are China and Mexico.
 - c. According to Gray, high individualism is associated with professionalism, flexibility, optimism, and transparency. (Note to instructors: After reading Chapters 3 and 4, students will recognize that these characterize Dutch, U.K., and U.S. accounting, but not French and German accounting. [Note also that the Netherlands, the United Kingdom,

and the United States have the highest individualism scores of all 10 countries.)) According to Gray, low individualism is associated with statutory control, uniformity, conservatism, and secrecy. (Note to instructors: After reading Chapters 3 and 4, students will recognize that only statutory control and [to some extent] secrecy is associated with China, whereas only secrecy is associated with Mexico. Gray's prediction for these two countries is not very good.) Medium individualism scores presumably predict accounting values "in the middle." (Note to instructors: After reading Chapters 3 and 4, students will recognize that the Czech Republic, India, and Japan do not really fall "in the middle" on Gray's accounting values. The Czech Republic and Japan generally reflect the accounting values of statutory control, uniformity, conservatism, and secrecy. India is generally associated with professionalism, flexibility, optimism, and transparency.)

7.
 - a. The uncertainty avoidance scores are: China (30), the Czech Republic (74), France (86), Germany (65), India (40), Japan (92), Mexico (82), the Netherlands (53), the United Kingdom (35), and the United States (46).
 - b. Countries with high uncertainty avoidance scores are the Czech Republic, France, Germany, Japan, and Mexico. Countries with medium uncertainty avoidance scores are India, the Netherlands, and the United States. Countries with low uncertainty avoidance scores are China and the United Kingdom.
 - c. According to Gray, high uncertainty avoidance is associated with statutory control, uniformity, conservatism, and secrecy. (Note to instructors: After reading Chapters 3 and 4, students will recognize that Gray's prediction describes accounting well for the Czech Republic, France, and Germany. The prediction describes Japan before the "Big Bang", but less so now. Except for secrecy, the prediction does not describe accounting values in Mexico.) According to Gray, low uncertainty avoidance is associated with professionalism, flexibility, optimism, and transparency. (Note to instructors: After reading Chapters 3 and 4, students will recognize that these are features of U.K. accounting, but not China.) Medium uncertainty avoidance scores presumably predict accounting values "in the middle." (Note to instructors: After reading Chapters 3 and 4, students will recognize that India, the Netherlands, and the United States have similar accounting values to the United Kingdom. Gray's prediction for these three countries is not very good.)
 - d. The only consistent prediction between Exercise 6 (individualism) and Exercise 7 (uncertainty avoidance) is that for the United Kingdom. Gray's model linking culture and accounting is valid for the United Kingdom. The model's predictions are exactly opposite for China, but in neither case does it predict China's accounting values very well. Based on individualism, the model does a "good job" predicting the accounting values in the Netherlands, the United Kingdom, and the United States, but a "poor or moderate" job predicting accounting values in the other seven countries. Based on uncertainty avoidance, the model does a "good job" predicting accounting values in the Czech Republic, France, Germany, Japan, and the United Kingdom, but a "poor or moderate" job prediction accounting in the other five countries. Overall, one would have to conclude that the success of Gray's model linking culture and accounting is modest at best.
8. The following table summarizes the use of IFRS by domestic listed companies in the 10 countries identified, according to the IAS Plus Web site at the time of writing:

	<u>Not permitted</u>	<u>Permitted</u>	<u>Required for Some</u>	<u>Required for All</u>
China	X			
Czech Republic				X
France				X
Germany				X
India	X			
Japan	X			
Mexico	X			
Netherlands				X
United Kingdom				X
United States	X			

The five countries of the European Union require their domestic listed companies to use IFRS. This EU requirement is discussed in this chapter. China, India, Japan, Mexico, and the United States require their domestic listed companies to use national GAAP, not IFRS. The implication is that these five countries believe that their own national standards better reflect financial reporting to various constituencies than do IFRS. However, Chapter 4 discusses that these five countries are converging their national GAAP with IFRS. Note 14 of the IAS Plus Web site (at the time of writing) notes that Chinese companies listed on the Hong Kong Stock Exchange are permitted to use IFRS or Hong Kong accounting standards. Note 8 states that India will adopt IFRS in 2011 and note 17 states that companies listed on the Mexican Stock Exchange will be required to use IFRS in 2012. Both developments are indicative of the global march toward IFRS, as mentioned in this chapter and discussed more fully in Chapter 8.

9. France: With banks and government as the main sources of finance, we can expect conservative and uniform measurements. With code law legal system, the focus is on complying with the law. The link to taxation means that measurements are also tax-oriented. Political and economic ties with the rest of Europe suggest that French accounting may influence and be influenced by other European countries. Low inflation indicates a low likelihood of inflation adjustments. The levels of economic development and education suggest sophisticated accounting.

India: With the government and stock market as the main sources of finance, we can expect a mixed (and inconsistent) orientation—uniformity but also fair presentation. The common law legal system and separation between tax and financial accounting indicate fair presentation accounting. The political and economic ties to the United Kingdom and the United States also suggest fair presentation accounting. (Economic ties to China are probably unimportant in describing Indian accounting.) Low inflation suggests a low likelihood of inflation adjustments. The levels of economic development and education suggest less complex accounting standards and practices.

Japan: With banks as the main source of finance, we can expect conservative accounting measurements. With the code law legal system, focus is on complying with the law. The link to taxation means that measurements are also tax-oriented. Political and economic ties to the United States indicate some U.S. influence on Japanese accounting. (Economic ties to China are probably unimportant in describing Japanese accounting.) Low inflation suggests a low

likelihood of inflation adjustments. The levels of economic development and education suggest sophisticated accounting.

United Kingdom: With the stock market as the main source of finance, we can expect fair presentation accounting. Fair presentation accounting can also be expected because the United Kingdom has common law, and taxation and accounting are separate (i.e., not linked). Political and economic ties to the United States and Europe suggest accounting influence is felt to and from both areas. Low inflation indicates a low likelihood of inflation adjustments. The levels of economic development and education suggest sophisticated accounting.

United States: With the stock market as the main source of finance, we can expect fair presentation accounting. Fair presentation accounting can also be expected because the United States has common law, and taxation and accounting are separate (i.e., not linked). Political and economic ties to Canada and Mexico most likely mean that these two countries are influenced by the United States, rather than the other way around. Low inflation indicates a low likelihood of inflation adjustments. The levels of economic development and education suggest sophisticated accounting.

10. The irreversible globalization of capital markets and increasing trend of multiple stock exchange listings is causing more and more companies to adopt fair presentation accounting for their worldwide audience. The chapter notes how accounting distinctions are becoming blurred. Chapter 3 also notes how Germany and Chapter 4 shows how Japan have established standard setting organizations for the purpose of adopting reporting standards for consolidated financial statements that are in line with International Financial Reporting Standards. Standard setters in the United States, Canada, Australia, and many other countries are committed to converging their financial reporting with IFRS. Finally, the European Union now requires EU-listed companies to follow IFRS in their consolidated financial statements from 2005 on.

Thus, we believe that the two-way split proposed in the chapter (fair presentation versus legal compliance) will be even more significant than it is now. Countries already oriented toward fair presentation (such as Australia, Canada, the Netherlands, United Kingdom, United States) will converge around International Financial Reporting Standards. Regardless of the home country of the company concerned, consolidated financial statements will be prepared on a fair presentation/full disclosure basis, as can be seen in the EU 2005 requirement. Countries that traditionally stressed legal compliance accounting, such as France and Germany, will continue to use this type of accounting for individual company financial statements. In other words, there will be dual reporting in these countries—fair presentation accounting in consolidated financial statements and legal compliance accounting in individual company financial statements.

Case 2-1 **Are Classifications of Accounting Outmoded?**

1. The comments by Mr. Cairns are inconsistent with ideas put forth in this chapter as well as most international accounting observers. Although it is true that classifications are simplifications, they are hardly simplistic. For the most part, we believe that accounting practices and standards still retain distinctive national characteristics. The classifications in this chapter help one get a handle on the essential points of difference and similarity in the observable features of accounting around the world. We therefore disagree with Cairns's assertions contained in the quote.
2. However, it does seem that for a select segment of the corporate world, the classifications discussed in the chapter are less (or ir-) relevant. World class companies, multinationals with multiple share listings around the world, are increasingly tailoring their financial reports for a sophisticated, worldwide user group that has essentially similar demands for information. It is the pursuit of international capital that seems to be driving this phenomenon. Thus, one should distinguish financial reporting at the domestic level from that at the international level, especially for companies from countries such as Japan, Germany, Sweden, and Switzerland that have a legalistic/tax compliance orientation of accounting at the national level. There is truth in Cairns's comments for this group of companies. (Given Mr. Cairns's association with the IASC, perhaps it was this group of companies that he was implicitly referring to.) Besides the drive for international capital, changes in information technology (e.g., the Internet) that allow instantaneous access to information and 24-hour trading in securities are also driving this result. And, as Mr. Cairns notes, standard setters from around the world are increasingly talking to one another in an attempt to develop compatible standards.

Note: The instructor may want to refer to Christopher Nobes, The Future Shape of Harmonization: Some Replies, *European Accounting Review*, Vol. 7. No. 2 1998, pp. 323–333. Nobes refutes several of Cairns's points.

Case 2-2 **Volkswagen Group**

1. Germany is a code law country with legal compliance accounting. Thus, German accounting may be characterized as tax-determined, with conservative measurements and income smoothing. Legal form dominates economic substance. Banks are the primary source of finance and it is likely that they prefer the safety net that conservative measurements and stable income affords. Tax authorities also prefer these features of accounting. As a code law country, accounting requirements are incorporated into law.
2. Conservative measurements are most obvious in the different balances for capital and reserves according to German Commercial Code (€9,811) versus IAS (€20,918). Conservative measurements are also illustrated by the noncapitalization of development costs, inventory overhead, and leases; and the valuation of derivative financial instruments at cost rather than fair value. Provisions (€2,022) are an income smoothing device. Income is also smoother when derivatives are valued at cost rather than fair value. Tax-influenced accounting is illustrated by depreciation (€3,483) and the fact that deferred taxes (€1,345) are not provided for (under German accounting).

Capital and reserves according to the German Commercial

Code as at January 1 2000	9,811
Capitalization of development costs	3,982
CONSERVATISM	
Amended useful lives and depreciation methods	
in respect of tangible and intangible assets	3,483
TAX-INFLUENCED; FORM OVER SUBSTANCE	
Capitalization of overheads in inventories	653
CONSERVATISM	
Different treatments of leasing contracts as lessor	1,962
FORM OVER SUBSTANCE	
Differing valuation of financial instruments	897
CONSERVATISM	
Effect of deferred taxes	-1,345
TAX-INFLUENCED	
Elimination of special items	262
Amended valuation of pension and similar obligations	-633
FORM OVER SUBSTANCE (MAYBE)	
Amended accounting treatment of provisions	2,022
SMOOTHING	
Classification of minority interests not as part of equity	-197
Other changes	21
Capital and reserves according to IAS as at January 1, 2000	20,918

3. Companies from code law countries are increasingly adopting fair presentation accounting in their consolidated financial statements. Volkswagen's adoption of IAS (now IFRS) in 2001 illustrates this trend. Your authors argue that a classification based on fair presentation versus legal compliance better reflects accounting in the world today than a classification based on legal system (code law versus common law). Volkswagen's adoption of IAS supports this position. Volkswagen, a German company, began using fair presentation principles (i.e., IAS/IFRS) in its consolidated statements, not legal compliance principles as under German Commercial Code.