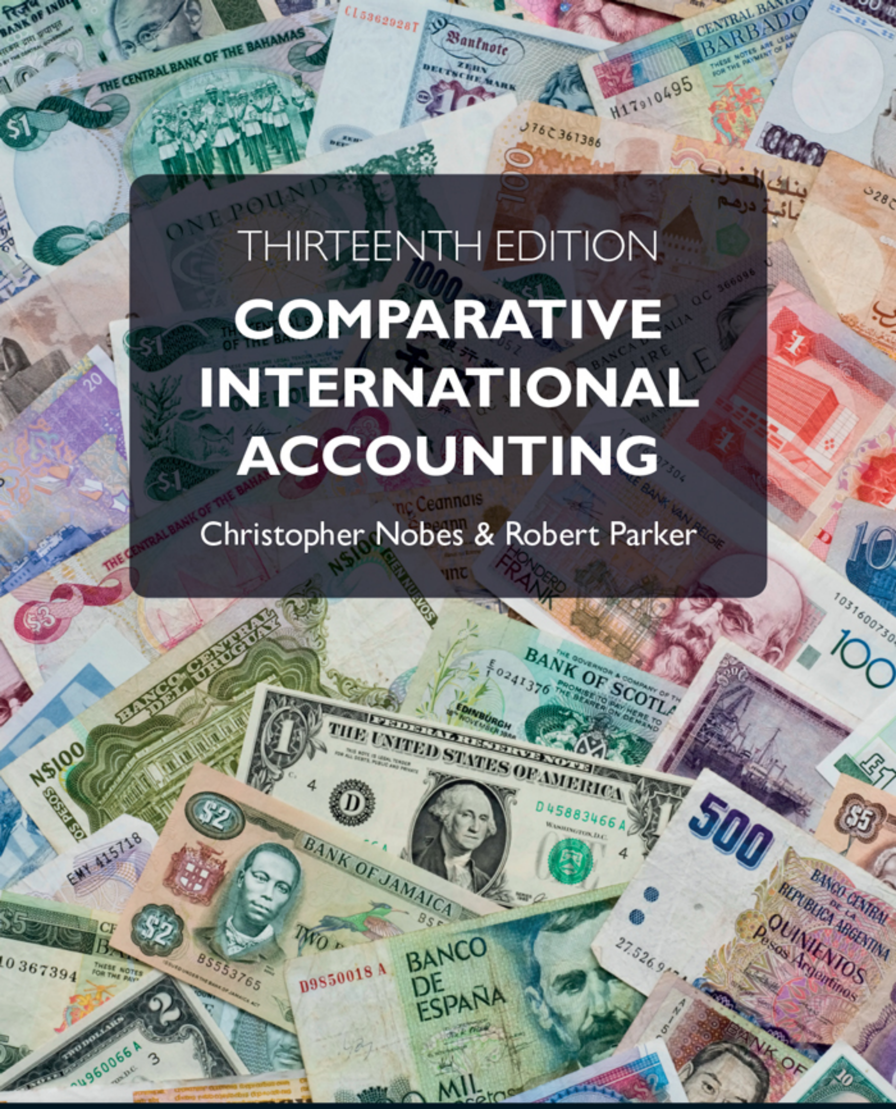

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Christopher Nobes

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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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Figures

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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
Royal Holloway, and University of Sydney
Robert Parker
University of Exeter

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Part I

SETTING THE SCENE

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1 Introduction

CONTENTS

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