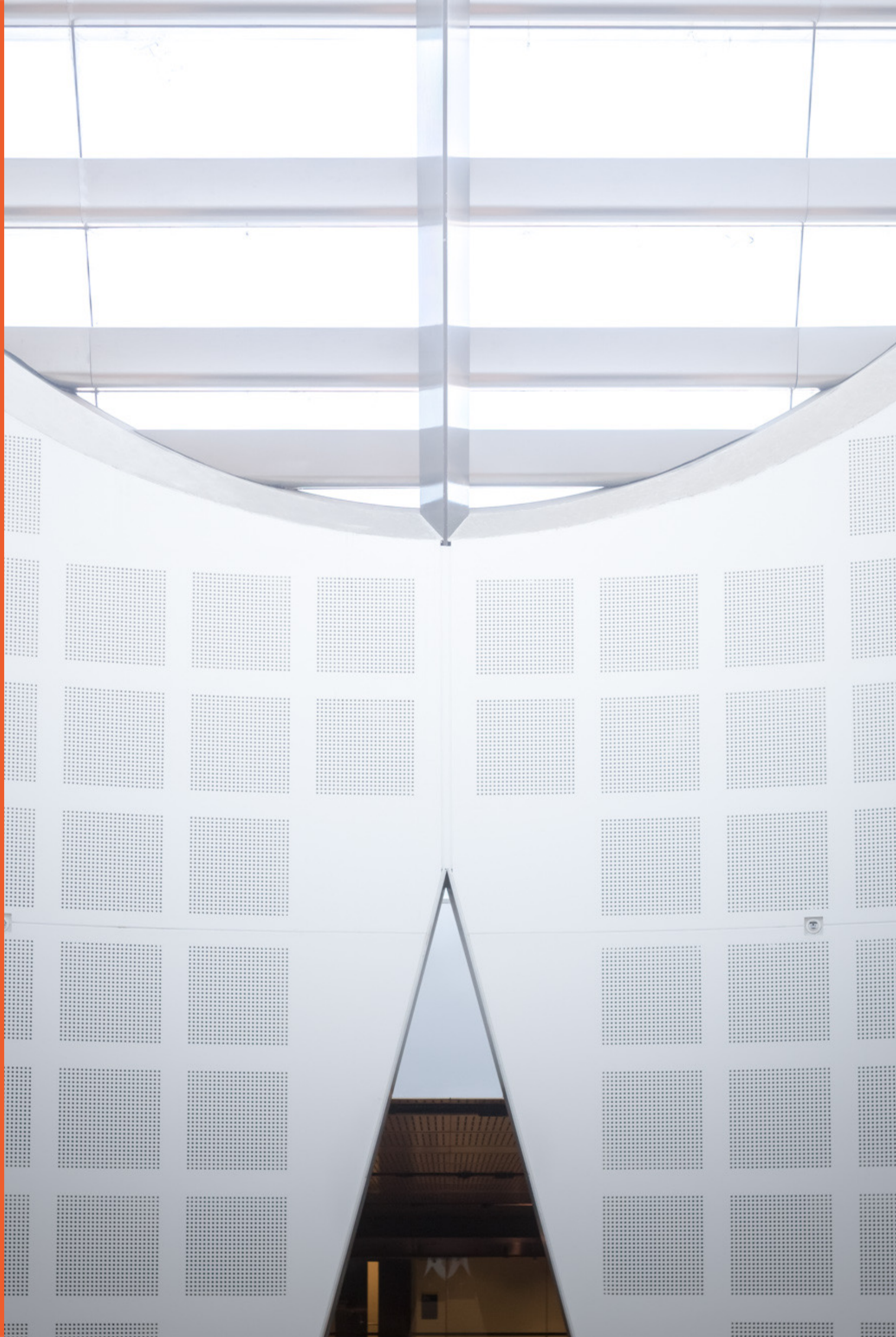
ACCT 6002

Causes of international differences

THE UNIVERSITY OF SYDNEY



Causes of international difference

- **Text readings:**
- *Comparative International Accounting*:
  - Chapter 2, Sections 2.2 to 2.8

- **Academic paper, on Blackboard:** Nobes, C.W., 'Towards a general model of the reasons for international differences in financial reporting', *Abacus*, Vol. 34, No. 2, 1998, pp.162-87.

- **Self-Study Questions:** See Canvas for instructions

Learning objectives

After this week's studies, 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 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.

Differences

- Last week, we talked about international differences in accounting regulation and practices
- We mainly used examples of the differences between IFRS and US GAAP – we will return to this in week 6
- This week, we discuss the causes of these differences
- There is plenty of research into this, but researchers have come to different conclusions
- We can suggest causes that are plausible, but <u>it is not possible to be absolutely *sure* of the cause</u>
- For the purposes of this unit, accounting means published financial reporting

Causes Suggested in the Literature

1 Nature of business ownership and financing system
2 Colonial inheritance
3 Invasions
4 Taxation
5 Inflation
6 Level of education
7 Age and size of accountancy profession
8 Stage of economic development
9 Legal systems
10 Culture
11 History
12 Geography
13 Language
14 Influence of theory
15 Political systems, social climate
16 Religion
17 Accidents

Reducing the number of alleged causes

- Which of the 17 are too vague to be useful as explanations?
- Which seem to be unlikely to cause accounting differences?
- Which might be results of the accounting differences, rather than causes of them?

Our focus

We focus on four of these ‘causes’:

1. Culture?

2. Taxation?

3. Legal systems

4. Financing of companies

1. Culture?

Accounting is affected by its environment, including culture.

Hofstede (1980) developed a model of culture as "the collective programming of the mind".
Based on a study of 100,000 IBM employees in 39 countries

The study argued that the members of one group of people could be distinguished from another based on 4 binaries:

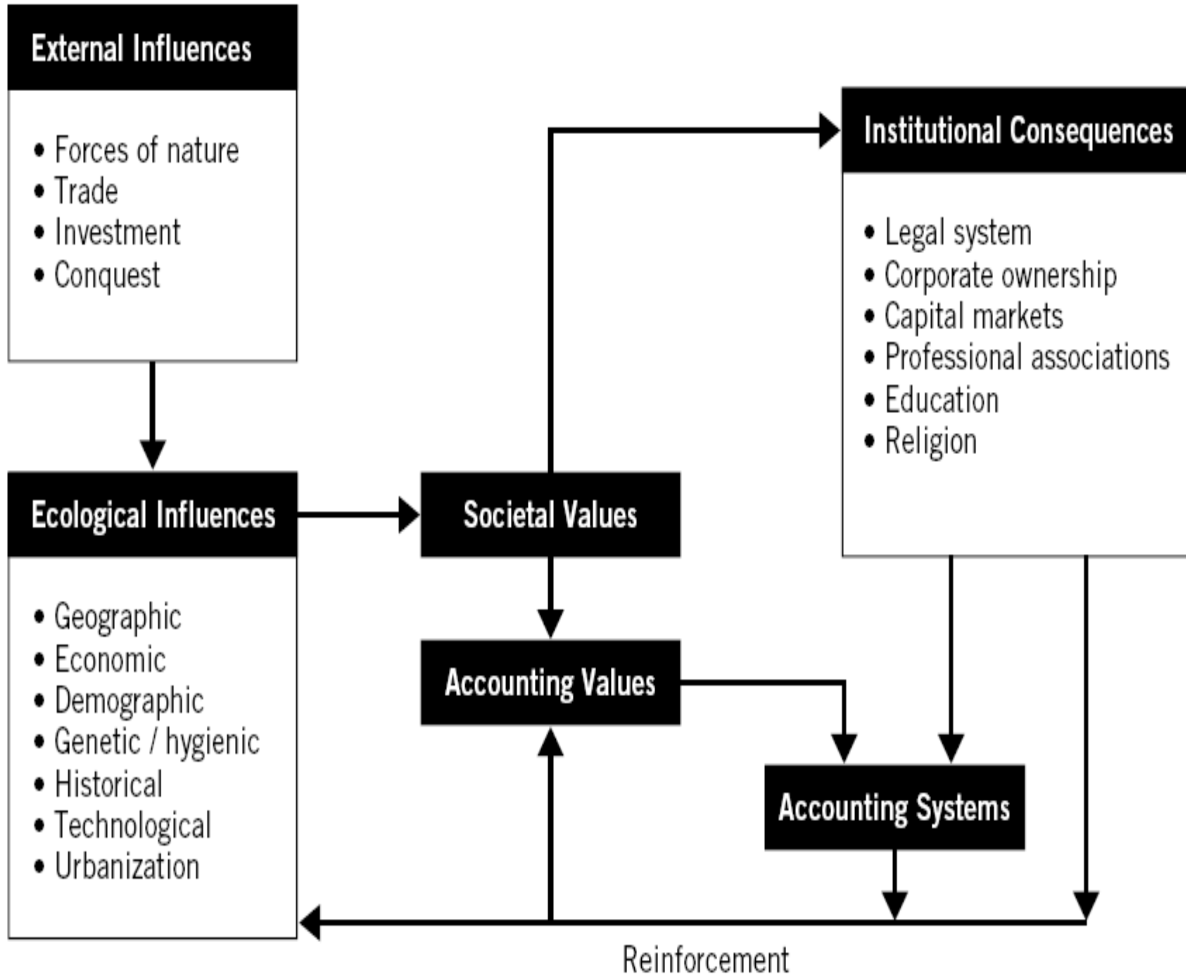
- Individualism v collectivism
- Large v small power distance
- Strong v weak uncertainty avoidance
- Masculinity v femininity

1. Culture?

Gray (1988) used these ideas to consider the ways in which accounting is affected by culture

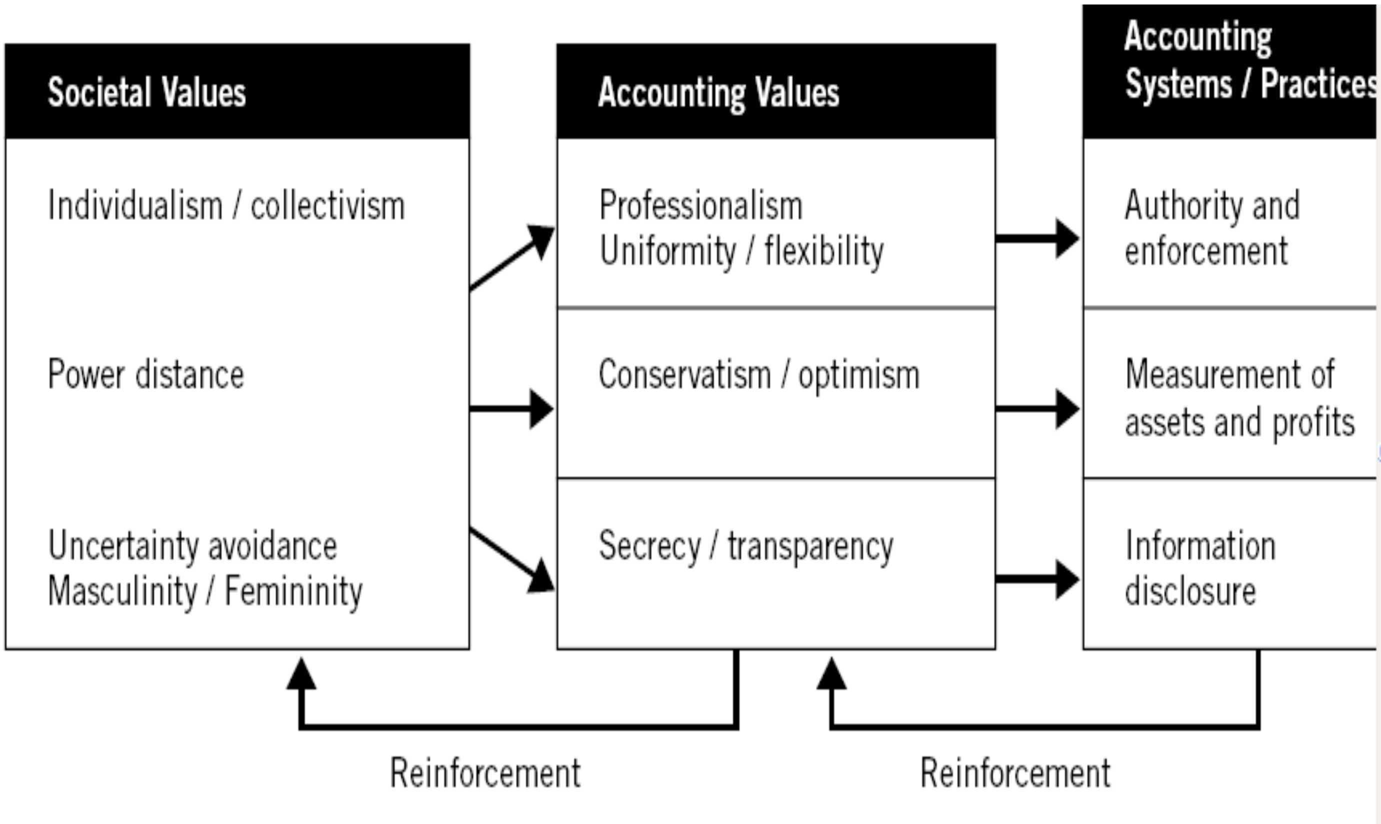
- He argued that societal values will influence institutions (legal, political, education) and practices (accounting)
- In what ways do cultural differences explain international differences in the behavior of accountants? And the nature of accounting practices?
- For example, a country with high uncertainty avoidance and low individualism may prefer conservative measurements of income
- Gray used Hofstede's framework to develop this one of accounting:
  - Professionalism v statutory control
  - Uniformity v flexibility
  - Conservatism v optimism
  - Secrecy v transparency

Cultural Influences on Accounting Systems



Source: S.J. Gray, Abacus, 1988

Culture and Accounting Systems/ Practices



LINKING SOCIETAL and ACCOUNTING VALUES: in theory

Accounting Values	PD	IDV	UAI	MASC	LTO
Professional v Statutory Control	LOW	HIGH	LOW	HIGH	LOW (short)
Uniformity v Flexibility	HIGH	LOW	HIGH		
Conservatism v Optimism		LOW	HIGH	LOW	HIGH (long)
Secrecy v Transparency	HIGH	LOW	HIGH	LOW	HIGH (long)

(Chand, 2011)

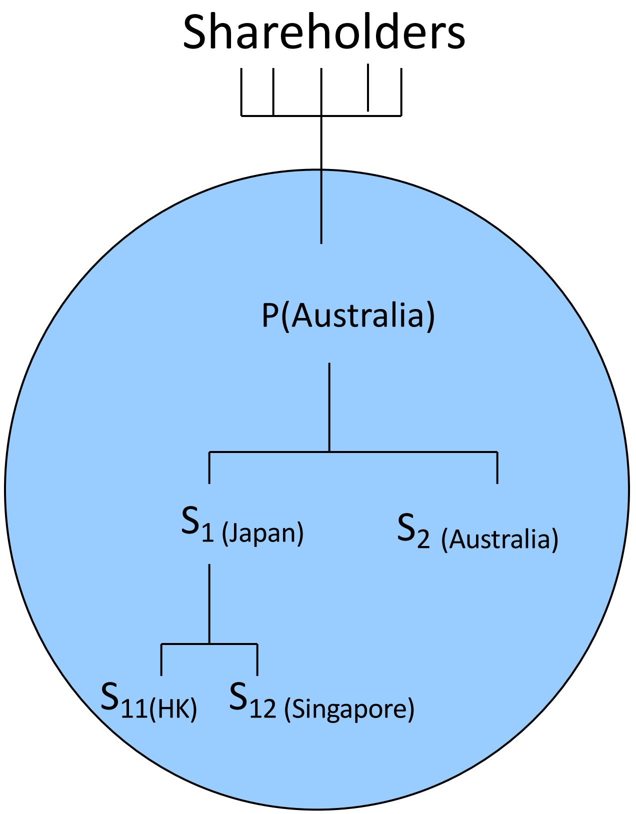
Problem with relying on culture as the cause of accounting differences

- Difficult to apply?
- Is a nation representative of a culture?
- Organizations are made up of people from a variety of cultures, so how would this explain accounting choices?
- Maybe we need to think more about the institutions that affect accounting, such as the tax systems, legal system, patterns of corporate financing?
- Of course, these are in part a product of culture, but the relationship between these and accounting differences may be more identifiable?

2. Taxation?

- The degree to which tax regulations determine accounting measurements can cause international differences
- In France, Germany and Japan, until recently, tax accounts were the same as commercial accounts. There is still a large influence of tax.

Foreign subsidiaries



Some Areas of Potential Tax Connection

1.
2.
3.
4. Long-term contracts
5. Inventory valuation
6. Lease capitalisation

Tax Connections?

– What other expenses might a company try to make larger, in order to make profit smaller, in order to pay less tax (at least in some countries)?

Some Areas of Potential Tax Connection

1. Depreciation, impairment of PPE
2. Asset measurement (cost or fair value)
3. Bad debt impairments
4. Long-term contracts
5. Inventory valuation
6. Lease capitalisation

Depreciation (I)

- In Australia and the UK:
  - The amount charged in published financial reports is determined by conventions within industries rather than precise rules
  - In AASB 116 and UK equivalent, there is scope to decide the method, the residual value, and the length of life
  - Depreciation is not tax-deductible
  - The amount of depreciation allowed for tax purposes is determined separately. You are allowed to deduct a certain amount for a certain type of asset over a certain period.

- So there is no judgement in tax calculations, but full room for judgement in accounting calculations

Depreciation (II)

- In Germany:
  - Tax regulations determine the maximum depreciation rates to be used for assets
  - These must be reflected in the method used in commercial accounts
- The introduction of IFRS requires disconnection of tax and accounting, but IFRS applies to consolidated statements, which are not relevant for tax
- See illustration of tax effects on depreciation in the Daimler accounts (p. 54), which are on Canvas.
  - The last year before it adopted US GAAP for reporting
- For France, see L'Oréal

Notes to the Consolidated Financial Statements
Summary of Significant Accounting Policies

The consolidated financial statements have been prepared in accordance with German generally accepted accounting principles (German GAAP). All amounts shown herein are in millions of German marks (DM). The items combined in the balance sheet as well as in the statement of income are listed separately and explained in the notes.

Accounting and Valuation

Where the circumstances are the same within the consolidated group, assets and liabilities are valued uniformly in the consolidated financial statements.

Intangible assets are valued at acquisition cost and are amortized on a straight-line basis. Goodwill resulting from a capital consolidation is amortized over a period of 20 years, provided it is not charged to consolidated reserves.

Property, plant and equipment is valued at acquisition or manufacturing cost, less accelerated depreciation. Additional depreciation is recorded where a lower reported amount is required. In addition, where applicable, accelerated depreciation methods are used in Germany pursuant to certain sections of the German tax guidelines, such as § 4 of the Development Area Act and § 6b of the Income Tax Act.

The manufacturing costs of company-built equipment and facilities cover direct costs, as well as allocable overhead costs of materials and manufacturing, including depreciation.

Property, plant and equipment is depreciated over the following useful lives: 10 to 50 years for buildings, 8 to 20 years for site improvements, 3 to 20 years for technical equipment and machinery and 2 to 10 years for factory, office and other equipment. If equipment is used in multiple shift operations, the useful life is reduced accordingly.

Buildings are depreciated using the greater of the straight-line method or the declining balance method. Moveable property in Germany having a useful life of four years or more is primarily depreciated using the declining balance method. We employ the straight-line depreciation method as soon as even distribution of the residual book value over the remaining useful life yields larger depreciation allowances. For foreign companies, moveable property is depreciated for the most part using the straight-line method.

Depreciation on plant, property and equipment additions in Germany during the first and second half of the year is calculated using full or half-year rates, respectively, on the basis of the tax simplification rule. Items having an immaterial value are expensed when purchased.

Investments in affiliated companies and *other financial assets* are valued at the lower of cost or market; long-term non-interest or low-interest bearing loans are recorded at present value. Significant *investments in associated companies* are valued at equity according to the book value method.

Leased equipment is valued at acquisition or manufacturing cost. It is depreciated to residual value primarily using the declining balance method. We employ the straight-line depreciation method as soon as even distribution of the residual book value over the remaining useful life yields larger depreciation allowances.

Raw materials, supplies and goods purchased for resale are valued at the lower of cost or market; *finished goods* are valued at manufacturing costs. Manufacturing costs include direct material, labor and applicable manufacturing overhead including depreciation. Loss provisions are recorded for inventories that have long periods of storage or changes in design.

Short-term securities are valued at lower of cost or market as of the balance sheet date.

Non-interest or low-interest bearing *receivables and other assets* with more than one year remaining to maturity are discounted as of the balance sheet date and valued after taking into account all known risks. An allowance for doubtful accounts is deducted from the receivables.

Provisions for pensions and similar obligations, including post-retirement medical benefits for retirees of U.S. subsidiaries, are actuarially determined on the basis of an assumed interest rate of 6% using the entry age actuarial cost method.

Provisions for taxes and other provisions have been recorded using the principles of reasonable accounting valuation. The obligations in employee benefits and social costs are generally recorded using the entry age actual cost method. Derivative financial instruments such as currency hedges (forward exchange transactions and currency options) and interest hedges (primarily interest rate and currency swaps and futures) are valued individually. If there is a direct relationship between a derivative financial instrument and a basic transaction, a valuation unit is formed. Provisions exist for interest rate and currency risks as well as for general credit risk.

Liabilities are recorded at their repayment amount.

Translation problem from German to English; these are done by agencies and not accountants.

This sentence is actually about impairment!

No one in Australia uses this:
It allows you to expense more earlier and reduce taxable income.
But if your users are shareholders, then inflating expenses is not useful information.

Translation error? "everything but land and buildings"

Different treatment for "foreign" companies

Again, reference to German tax

Write-offs (German; English; French)

Abschreibung(en)

planmässiger Abschreibung

depreciation

amortissement

ausserplanmässige Abschreibung

impairment

dépréciation

Some Areas of Potential Tax Connection

1. Depreciation, impairment of PPE
2. Asset measurement (cost or fair value)
3. Bad debt impairments
4. Long-term contracts
5. Inventory valuation
6. Lease capitalisation

LIFO

Allowed

Germany, Italy, France (consolidated), US

Banned

UK, France (unconsolidated), IFRS, China

Capitalisation of leases by lessees

Required for all leases

IFRS, US*

Required for finance leases

IFRS for SMEs, UK

Allowed

France (finance leases in consolidated accounts)

Banned

France (unconsolidated), Germany (mostly), Italy

**more exceptions for certain short-term leases*

Problem with relying on tax as the cause of accounting differences

- It does not explain why tax dominates financial reporting in Germany/France/Japan but not in UK/US/Australia

3. Legal systems: Code law or Common law

- Codified (Roman) law:
  - a system started in the Roman empire, where rules are linked to ideas of justice and morality
  - centralized detailed laws on many matters
  - found in France, Germany, South America
  - Japan and China borrowed the German commercial legal system
- How does this affect accounting?
  - company law or commercial codes establish the rules for accounting, so there is no room for 'accounting standards' set by accountants

Legal systems: common law

- Common Law (English law):
  - Relies on a limited amount of statute law
  - This is interpreted by the courts to build up case law
  - Seeks to provide legal solutions to the specific case, rather than generate a general rule that applies in all circumstances
  - Originates in England, but can now be found across the world: Australia, HK, US, Canada, India, New Zealand
- How does this affect accounting?
  - Influences commercial law, which does not tend to prescribe detailed rules on financial reporting
  - Instead, accountants themselves established rules for preparing accounting practice in the form of recommendations or standards
  - In many of these countries standard-setting bodies (independent from the state and now from the profession) have been set up
  - Usually, the legal system is involved in the enforcement of standards

Comparing Legal Systems (for commercial law)

Common law	Codified law
England and Wales	France
Ireland	Italy
United States	Germany
Canada	Spain
Australia	South America
New Zealand	Netherlands
India	Portugal
Hong Kong (SAR)	Japan
Singapore	China (PRC except HK)

Problems with relying on legal system as the cause of accounting differences?

- The Netherlands has Roman law but UK/US-style accounting
- Germany has Roman law but was the first major country in which companies volunteered to use IFRS (from 1994)

3. Providers of Finance

- The types of business organization and ownership differ around the world
- In Germany, France and Italy:
  - banks provide much of the finance for businesses
  - there are many small family-owned business, fewer listed companies
- In the US and the UK:
  - more reliant on shareholders for finance
  - institutional investors
  - larger listed companies

- This affects the purpose of accounting information
- It is possible that common law leads to strong equity markets which leads to IFRS-style accounting

Major Stock Exchanges, August 2018

Country	Exchange	Domestic listed companies	Market cap. of domestic equities ($bn)	Market capitalization as % of NYSE
Europe				
-	Euronext	1,078	4,370	18
Germany	Deutsche Börse	460	2,147	9
Switzerland	SIX	235	1,611	7
United Kingdom	London	2,079	4,147	17
The Americas				
Canada	Toronto	3,316	2,297	9
United States	NASDAQ	2,608	11,971	49
	New York	1,780	24,239	100
Asia-Pacific				
China	Hong Kong	2,107	4,104	17
	Shanghai	1,440	4,254	18
	Shenzhen	2,117	2,709	11
India	Bombay	5,068	2,248	9
Japan	Tokyo	3,630	6,050	25
S. Korea	Seoul	2,149	1,642	7
Australia	Australian	2,151	1,449	6

Measures of Equity Markets: Europe

The equity market in the UK is more important than in Italy, and this may affect the nature and purpose of financial reporting: the users will be different, and their needs will be different

It is likely that countries near the top need accounting to serve investors

Whereas countries towards the bottom, with smaller capital markets, may need accounting that serves lenders or tax authorities.

	Domestic Listed Companies per Population (m)
UK	42.4
Netherlands	23.2
Sweden	28.2
Belgium	14.0
France	12.9
Spain	9.7
Germany	8.6
Italy	4.1

Questions

1. What is the purpose of accounting in the USA and under IFRS?

   – Give useful information to investors

2. What is the purpose of accounting in Germany (at least for individual company reporting)?

   – Give information to the tax department

   – Calculate distributable income, to control the size of dividends and protect creditors

	US, UK, IFRS	France, Germany, Italy
Purpose?	Prediction of cash flows by investors	Calculation of taxable income and distributable income
Who is in charge of the accounting rules?	Accountants, stock exchanges	The state
Who for?	Groups	Individual companies

In the US, the only published financial reports are of groups. There are no published financial reports for the individual entity

In France, they would regard the individual legal entity as the real focus of accounting. Company by company they pay tax, and they pay dividends. So this forms the basis of the accounting.

Sources of information on various countries

https://www.icaew.com/en/technical/by-country

Academic article

- Nobes, C.W., ‘Towards a general model of the reasons for international differences in financial reporting’, *Abacus*, Vol. 34, No. 2, 1998, pp.162-87

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

Countries change

- Nobes (1998) argues that the differentiation between credit/insiders and equity/outsider is the key cause of international differences
- For countries with a growing set of equity/outsider interests, like China or Germany, the country can introduce a set of rules such as IFRS for consolidated statements, while maintaining domestic GAAP for individual companies

ABACUS, Vol. 34, No. 2, 1998

CHRISTOPHER NOBES

Towards a General Model of the Reasons for International Differences in Financial Reporting

The article first examines the existing modelling literature, which contains a large number of suggested reasons for international differences in accounting. After examining terminological problems, a preliminary parsimonious model is developed to explain the initial split of accounting systems into two classes. The term 'accounting system' is used here to mean the financial reporting practices used by an enterprise. A country might exhibit the use of several such systems in any one year or over time. Consequently, it should be systems and not countries that are classified. The model proposes a two-way classification using two variables: the strengths of equity markets and the degree of cultural dominance. Implications for classifiers and rule-makers are suggested.

Key words: Classification; International accounting.

INTRODUCTION AND PREVIOUS MODELLING

Many reasons have been suggested in the literature for international differences in financial reporting. Some authors state that they are merely listing plausible reasons; few provide precise hypotheses or tests of them, as noted by Meek and Saudagaran (1990). Wallace and Gernon (1991) complain about the lack of theory in international comparative accounting. This article seeks to address this.

The literature (e.g., Choi and Mueller, 1992, ch. 2; Radebaugh and Gray, 1993, ch. 3; Belkaoui, 1995, ch. 2; Nobes and Parker, 1995, ch. 1) offers a large number of possible reasons for international differences (see Table 1) but no general theory linking the factors. Schweikart (1985) and Harrison and McKinnon (1986) provide some elements of a general theory, without specifying which factors are major explanatory variables for accounting practices. Two somewhat similar theoretical models of the reasons for accounting differences are those of Gray (1988) and of Doupnik and Salter (1995; hereafter DS). Gray suggests a model based on cultural factors, as examined later. DS provide a synthesis of previous discussions, leading to a framework, which is simplified here as in Figure 1 so that an alternative can

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CHRISTOPHER NOBES is Coopers & Lybrand Professor of Accounting at the University of Reading.
The author is grateful for helpful comments on earlier drafts from Michael Page, Bob Parker, Alan Roberts and Autar Singh, and from the editor and the referees of this journal.

Answer these questions each week:

From the reading list provided on Canvas, each group must discuss two academic articles that relate to their topic (approximately 5 minutes each article).

a. The discussion must include reference to:

i. The title

ii. The publication details

- when was it published?
- Which journal was it published in?
- Who wrote it?
- Where are the authors from?

iii. The key research questions posed in the article

iv. The approach adopted to answer these questions (what data was used?)

v. The findings?

b. In what ways do your two chosen articles relate to each other?