2. International differences before IFRS

2.1 DEFINING SOME TERMS

One of the problems in identifying reasons for accounting differences, and then classifying accounting systems into groups, is a lack of clarity about what is being examined or classified. This report discusses accounting practices, using 'accounting' to mean published financial reporting. In some jurisdictions, the rules of financial reporting may be identical or very similar to the practices, but sometimes a company may depart from rules or may have to make choices in the absence of rules. So, it seems more pertinent to discuss actual practices rather than formal rules.

Another difficulty concerns the word 'system'. It sometimes includes entities such as regulatory agencies, whereas other uses of the term refer to a corpus of accounting rules or practices. This report follows the latter usage; that is, an 'accounting system' is a set of practices used in a published annual report. Although this is a narrow definition, these practices will reflect the wider context in which that accounting system operates. Yet another issue is whether to separate disclosure from measurement practices. It seems appropriate to include the presence or absence of certain key disclosures (eg earnings per share, cash flow statements) as elements of an accounting system.

A further issue is to determine whose accounting practices are being examined. In general, this report will discuss listed companies, because their accounting is easy to inspect and can benefit from international harmonisation.

A related point is that all the researchers[2] classify countries. A country can have more than one system – one for companies with publicly traded securities and another for small private companies.

In addition, a country's accounting system may change dramatically; for example as a result of economic or political revolutions (eg China, Russia, Poland). In addition, accounting in a country can change quite significantly as a result of new laws (eg in Spain from the late 1980s, as a consequence of EU Directives). Lastly, companies in two countries (eg the UK and Ireland) can use extremely similar accounting practices (ie perhaps the same 'system').

The detailed elements of accounting practice can differ so much from one company to another that the number of different sets of practices is effectively infinite. A certain degree of variation among company practices may be allowed, however, without having to abandon the idea that the companies are all using the same system.

2. Such as: Nair and Frank (1980); Nobes (1983); Doupnik and Salter (1993).

2.2 A SIMPLE MODEL

The academic literature[3] offers a large number of possible reasons for international differences in accounting. The explanation can be dramatically simplified by suggesting a single main factor: how companies are financed. This factor has two dimensions, as shown in Table 2.1.

'Insiders' are investors (in equity or debt) who have long-term relationships with the company. They can appoint board members, or may have special access to information. Examples are: family members (even in large listed companies, eg Fiat); banks (as big lenders or as major equity holders, eg Daimler); and governments (eg Renault).

By contrast, 'outsiders' are the millions of shareholders who have small percentages of shares or listed debt. Included in this group are large shareholders (eg pension funds in the US or UK) as long as they have no privileged access to company information (because, for example, that would break insider-dealing laws in the country concerned).

Examples of the financing systems are as follows.

- **System I** (credit/insiders) is associated with several continental European countries in the 19th and 20th centuries.
- **System II** (credit/outsiders) might be rare, but there is a vast amount of listed debt on the New York Stock Exchange.
- **System III** (equity/insiders), elements of which are seen in Japan.
- **System IV** (equity/outsiders) is the full-blown capitalism of New York and London. China has moved towards System IV but the State (an insider) still holds much equity.

Table 2.1: Financing systems

Dominant investors	Strong credit	Strong equity
Insiders	I	III
Outsiders	II	IV

3. Choi and Mueller (1992) ch.2; Radebaugh et al. (2006) ch.3; Belkaoui (1995) ch.2; Nobes and Parker (2010) ch.1.

There are two caveats to this.

- Countries might have more than one of the four systems; for example, System IV (equity/outsiders) for big companies and System I (credit/insiders) for small ones. This report concentrates on the bulk of a country's economic activity; for the US and the UK, for example, that means listed companies.

- Countries change over time, but accounting might change more slowly and will be influenced by the past.

Some simple measures of equity market size are given in Table 2.2. Listed companies and equity markets are obviously much less important in Italy and Germany than they are in the UK and the US.

The starkest contrast is between System I and System IV. Concentrating on these, the following are relevant points.

- In a country (or in a sector of a country) dominated by equity/outsiders (System IV), there will be a demand for detailed, audited, frequent, published accounting information.

- The conceptual frameworks of the IASB and of standard setters in Australia, Canada, the UK and the US state that the purpose of financial reporting is primarily to enable investors to make economic decisions. This is clearly a System IV orientation.

Table 2.2: The strength of equity markets, 2009

	Domestic listed companies per million of population	Equity market capitalisation as % of GDP
Italy	5.1	0.19
Germany	9.0	0.28
United States	18.0	0.81
United Kingdom	39.3	0.55

Source: Nobes and Parker (2010: 33)

- In a country (or in a sector of a country) dominated by credit/insiders (System I), there will be no such demand for investor-oriented reporting. For such countries, in the absence of an outsider purpose, accounting will serve its traditional purposes: calculating prudently distributable profit and calculating taxable income. System I purposes are legal in nature and relate to single entities, therefore the detail of accounting tends to be controlled by the State and will concentrate on unconsolidated statements. By contrast, in equity/outsider (System IV) countries, the detail of accounting will be controlled by bodies connected to accountants or stock markets.

The two classes of accounting that result have the features listed in Table 2.3. These features are found in the following cases. All the features of Class A in Table 2.3 were found in the national practices of Australia, the UK and the US. All the features of Class B are found in the unconsolidated statements of companies (even large ones) prepared under the national accounting rules of France, Germany or Italy.

Table 2.3: Examples of features of the two accounting classes

Feature	Class A	Class B
Depreciation and pension expenses	Accounting practice differs from tax rules	Accounting practice follows tax rules
Long-term contracts	Percentage of completion method	Completed contract method
Unsettled currency gains	Taken to income	Deferred or not recognised
Legal reserves	Not found	Required
Income statement format	Expenses recorded by function (eg cost of sales)	Expenses recorded by nature (eg total wages)
Cash flow statements	Required	Not required, found only sporadically
Earnings per share disclosure	Required by listed companies	Not required, found only sporadically

2.3 WHY OTHER FACTORS ARE LESS USEFUL

There are various explanations as to why other important factors are less useful in explaining the main A/B split between the classes of accounting.

International differences in tax are of limited relevance in causing the A/B split of Table 2.3 because Class A is supposed to be unaffected by tax issues. There are some exceptions, such as the use of LIFO in the US for reporting purposes, in order to be allowed to use LIFO for tax. System IV financing causes Class A accounting, which is not designed to serve tax purposes. So, tax itself does not explain why a country is in Class A or Class B. Of course, within a set of countries that use Class B accounting, differences in tax are likely to be a major cause of differences in accounting.

International differences in legal systems are also of only limited relevance in causing the A/B split. Class A seems to be associated with common law countries, and Class B with Roman (codified) law countries, but there is not a perfect correlation. In addition, IFRS was adopted in some Roman law countries in the 1990s for the consolidated statements of listed companies. The EU (a very Roman law organisation) has adopted IFRS for this purpose. Nonetheless, the national legal system still affects monitoring and enforcement of accounting.

2.4 COLONIAL INFLUENCE

Colonial inheritance is probably the major explanatory factor for the general system of financial reporting in many countries outside Europe. For example, it is easy to predict how accounting will work in Gambia (a former British colony) compared with neighbouring Senegal (a former French colony). The same general point applies to predicting how accounting will work in Singapore or New Zealand, both of which must be expected to have British-influenced accounting. Colonial inheritance extends to legal systems and to other background and cultural factors, and not just to direct imports of accounting. Substantial capital investment from another country may also lead to accountants and accounting migrating with the capital.

Another related influence on accounting is invasions, which may have major effects, as is the case with Japanese,[4] French,[5] and German[6] accounting. When the invader departs, however, any foreign accounting measures can be gradually removed if they do not suit the country: Japan closed down its Securities and Exchange Commission when the Americans left, whereas France retained its German-inspired accounting plan in order to aid reconstruction after the Second World War.

2.5 EMPIRICAL EVIDENCE

The two-class model outlined in section 2.2 has been supported in the literature when researchers have examined accounting practices.[7] It can also be seen in measures of the differences between various national GAAPs and IFRS.[8] For example, in 2001, there were far fewer differences between UK GAAP and IFRS than there were between French or German GAAP and IFRS.

Other empirical studies look at the effects of moving from national GAAP to IFRS. Some of these look at 'value relevance', ie whether IFRS accounting numbers are more closely related than national GAAP to share price movements. The evidence[9] suggests that there is not much difference between US GAAP and IFRS for this purpose, but that IFRS is more value relevant than, for example, German GAAP. This is consistent with the model proposed here.

2.6 THE MODEL DEVELOPED

Section 2.2's simple model of the development of accounting based on corporate financing can now be elaborated. This fuller model consists of a number of linked ideas which will be expressed as propositions. Part of the model can be shown in simplified form as in Figure 2.1, which amends a diagram suggested by Doupnik and Salter (1995). The variables have been introduced in the text above, but now need to be marshalled.

The first variable is a country's type of legal and institutional culture, and the second is the strength of its equity-outsider financing. It can be assumed that some cultures develop strong equity-outsider markets and others do not. This is an issue for economic historians and is not examined in detail in this report. As discussed earlier, some countries have strong indigenous systems, whereas others have imported systems that are still dominated, or at least heavily influenced, from outside. This dichotomy will be expressed by using the labels SSC (for self-sufficient financial and legal culture) and DC (for dominated culture). For example, a DC country whose colonial inheritance came from a country with one type of financial culture would tend to have that same financial culture. This variable could be measured in various ways, for example by the number of decades since one country gained political independence from another. Many developed countries are SSC and many developing countries are DC, but there are exceptions.

4. Japan's SEC, its structure of Securities Laws and its stock market owed much to US influence during the occupation following the Second World War.

5. The distinguishing feature of French accounting, the *plan comptable*, was first adopted when France was under German occupation.

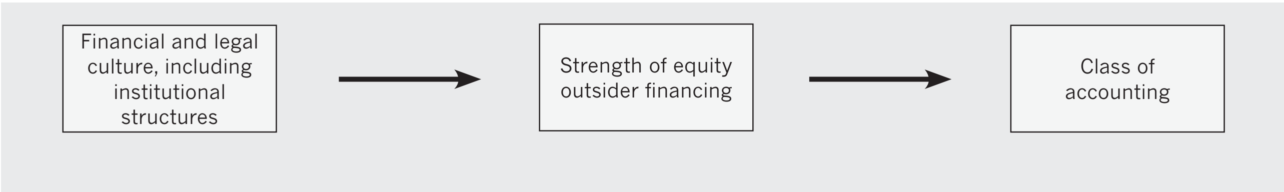
6. The German accounting plan, though copied in France, was abolished by the occupying Western powers after the Second World War. A version survived in communist East Germany until reunification.

7. Doupnik and Salter (1993).

8. Ding et al. (2007).

9. The evidence is summarised by S.J. McLeay in Section 20.5 of C.W. Nobes and R.H. Parker, *Comparative International Accounting*, Prentice Hall, 2010.

Figure 2.1: Simplified model of reasons for international accounting differences



As noted above, the second variable is the strength of equity/outsider financing. For most companies in any country (insider companies), a controlling stake is in the hands of a small number of owners. For a comparatively few companies (outsider companies), control is widely spread among many 'outsider' equity-holders. Countries with strong equity-outsider systems generally have a large number of outsider companies which may generate most of a country's GNP, but some such companies may also exist in other countries with different systems.

The final variable is the type of financial reporting system (or, in short, 'accounting system'), introduced earlier as Class A or Class B. As suggested above, this is the key driver of the type of accounting that will be needed.

The ideas which link these variables can now be brought together. It is worth repeating the point that more than one accounting system can be used in any particular country at any one time, or over time. The model can be expressed in terms of five propositions (P), which are then explained and illustrated.

P1: The dominant accounting system in an SSC country with a strong equity-outsider system is Class A.

P2: The dominant accounting system in an SSC country with a weak (or no) equity-outsider system is Class B.

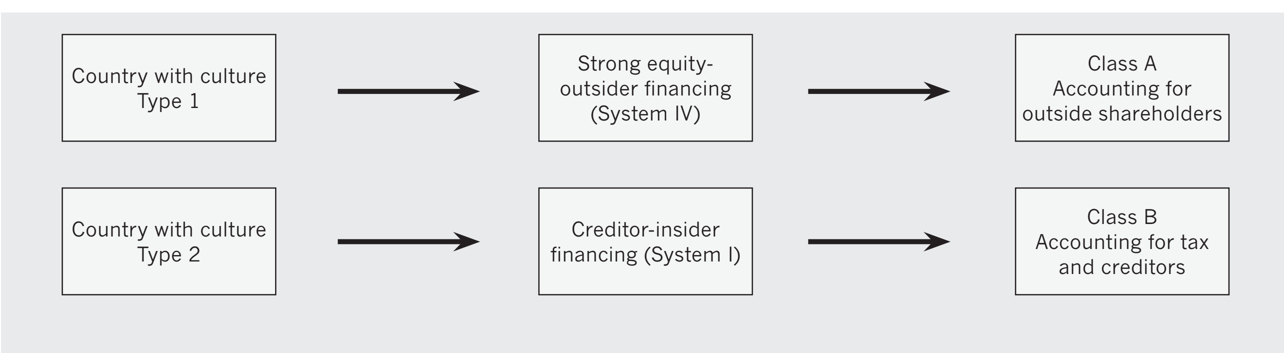
P3: As a country establishes a strong equity-outsider market, its accounting system moves from Class B to Class A.

P4: Outsider companies in countries with weak equity-outsider markets will move to Class A accounting.

P5: A DC country has an accounting system imported from the dominating country, irrespective of the strength of the DC country's equity-outsider system.

The analysis here relates to self-sufficient countries (P1 and P2), as illustrated in Figure 2.2. For these countries, it is suggested that a country's financing system will have resulted from its particular type of culture. As suggested earlier, for the purposes of this report, it is not necessary to go back that far in the chain in any detail. Let us say that 'Type 1' culture produces strong equity-outsider financing but 'Type 2' culture does not.

Figure 2.2: Application of Figure 2.1 to culturally self-sufficient countries



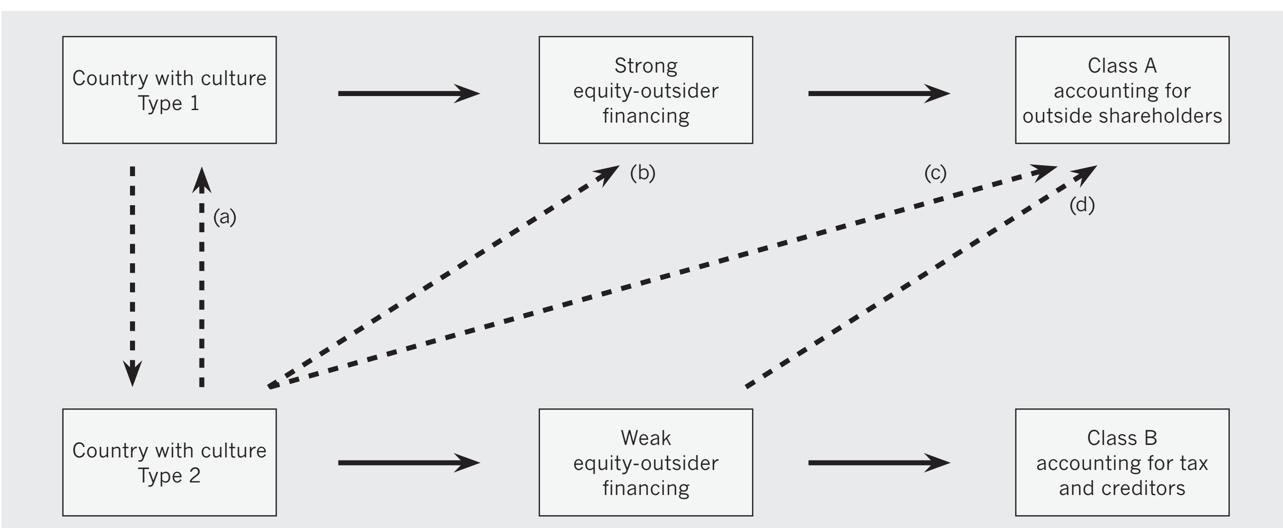
The class into which the predominant accounting system falls will depend upon the strength of the equity-outsider market (or on its strength in the past, if there is inertia). Strong equity-outsider systems will lead to Class A accounting (containing the features in Table 2.3 on page 10) whereas others will lead to Class B accounting. As explained earlier, the term 'predominant accounting system' refers to the type of system used by enterprises representing the majority of a country's economic activity. For example, small unlisted enterprises in strong equity market countries might not practise Class A accounting or indeed any financial reporting at all.

Proposition 3 is that, if a country with a traditionally weak equity market gradually develops a strong equity-outsider system, a change of accounting towards Class A will follow. Also (P4), in a country with weak equity-outsider markets, there may be some 'outsider companies' (as defined earlier). Commercial pressure will lead these companies towards Class A accounting, even if the dominant system in the country is Class B. For such companies, there will be rewards in terms of lower cost of capital[10] from the production of Class A statements, particularly if there is an international market in the company's shares. If legal constraints hinder movement towards Class A accounting, then the company can use extra disclosures or supplementary statements.

Figure 2.3 shows some aspects of these ideas. The continuous arrows are those from Figure 2.2. Arrow (b) relates to Proposition 3, and Arrow (d) Proposition 4. Arrows (a) and (c) concern Proposition 5. Some illustrations of these relationships are given below.

- Arrow (a): New Zealand is a DC country which has imported British culture and institutions wholesale, including a strong equity-outsider system and Class A accounting. Whether Class A accounting in this case results from the equity market or from direct cultural pressure is not important to the model; it probably arises from both.
- Arrow (b): China is a country that had no equity-outsider tradition but has moved towards such a system. Class A accounting has followed, for listed companies.
- Arrow (c): Malawi is a DC country with very weak equity markets but where the accountancy profession has adopted Class A accounting, consistent with its colonial inheritance from the UK.
- Arrow (d): the Deutsche Bank, Bayer and Nestlé are companies from countries with traditionally weak equity markets. These companies were interested in world equity-outsider markets, so they adopted Class A accounting (IFRS) for their consolidated statements in the 1990s.

Figure 2.3: A proposed model of reasons for international accounting differences



10. It is argued that equity investors and lenders will be persuaded to provide funds at lower returns to companies using more accepted, familiar and transparent financial reporting (Botosan 1997).