CHAPTER 2

Development and Classification

Accounting must respond to society's ever-changing informational needs and reflect the cultural, economic, legal, social, and political conditions within which it operates. The history of accounting and accountants reveals continuing change. At first, accounting was little more than a recording system for certain banking services and tax-collection schemes. Double-entry bookkeeping systems were later developed to meet the needs of trading ventures. Industrialization and division of labor made cost-behavior analysis and managerial accounting possible. The rise of the modern corporation stimulated periodic financial reporting and auditing. In keeping with society's increased concerns about the environment and about corporate integrity, accountants have found ways to measure and report environmental remediation liabilities and to uncover money laundering and other white-collar crimes. Accounting provides decision information for huge domestic and international public securities markets. It extends into management consulting and incorporates ever-increasing information technology within its systems and procedures.

Why should we want to know how and why accounting develops? The answer is the same as for developmental studies in other fields. We can better understand a nation's accounting by knowing the underlying factors that have influenced its development. Accounting differs around the world, and knowledge of the developmental factors helps us see why. In other words, they can explain the observable differences as well as the similarities. Because accounting responds to its environment, different cultural, economic, legal, and political environments produce different accounting systems, and similar environments produce similar systems.

This leads us to classification. Why should we classify (compare) national or regional financial accounting systems? Classification is fundamental to understanding and analyzing why and how national accounting systems differ. We can also analyze whether these systems are converging or diverging. The goal of classification is to group financial accounting systems according to their distinctive characteristics. Classifications reveal fundamental structures that group members have in common and that distinguish the various groups from each other. By identifying similarities and differences, our understanding of accounting systems is improved. Classifications are a way of viewing the world.

DEVELOPMENT

Every nation's accounting standards and practices result from a complex interaction of economic, historical, institutional, and cultural factors. Diversity among nations is to be expected. The factors that influence national accounting development also help explain the accounting diversity among nations.

The following eight factors have a significant influence on accounting development. The first seven are economic, sociohistorical, and/or institutional in nature, and they have occupied most of the attention of accounting writers. The relationship between culture (the eighth item) and accounting development ends the discussion in this section.

1. ***Sources of Finance.*** In countries with strong equity markets, such as the United States and the United Kingdom, accounting profits measure how well management is running the company. Accounting is designed to help investors assess future cash flows and the associated risks, and to value the firm. Disclosures are extensive to meet the requirements of widespread public share ownership. By contrast, in credit-based systems, where banks are the dominant source of finance, accounting focuses on creditor protection through conservative earnings measures to minimize dividend payouts and retain sufficient funds for the protection of lenders. Because financial institutions have direct access to any information they want, extensive public disclosures are not considered necessary. Japan and Switzerland are examples.[1]
2. ***Legal System.*** The legal system determines how individuals and institutions interact. The Western world has two basic orientations: code (or civil) law and common (or case) law. Code law derives mainly from Roman law and the Code Napoléon.[2] In code law countries, laws are an all-embracing set of requirements and procedures. Codification of accounting standards and procedures is natural and appropriate. Thus, in code law countries, accounting rules are incorporated into national laws and tend to be highly prescriptive and procedural.[3] By contrast, common law develops on a case-by-case basis with no attempt to cover all cases in an all-encompassing code. Statute law exists, of course, but it tends to be less detailed and more flexible than in a code law system. This encourages experimentation and permits the exercise of judgment.[4] Common law derives from English case law. In most common law countries, accounting rules are established by private sector professional organizations. This allows them to be more adaptive and innovative. Except for broad statutory requirements, most accounting rules are

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[1] For further discussion of this point, see C. Nobes, "Towards a General Model of the Reasons for International Differences in Financial Reporting," *Abacus* (September 1998): 162–187. He points out that outsiders (e.g., individual and institutional shareholders) normally dominate ownership in strong equity countries, causing a demand for high levels of disclosure. Insiders (families, other companies, government, and banks) usually dominate ownership in credit-based countries, which is why low levels of disclosure are usually found there. Germany is an exception. Although Germany is a credit-based country, German-listed companies have high disclosures because of Germany's unusually large market in listed debt (p. 169).

[2] There are three major families in the code law tradition: French, German, and Scandinavian. French and German code law, like the common law, spread around the world through conquest, imperialism, or borrowing.

[3] There are exceptions to this generalization; for example, the Netherlands (Chapter 3) and Mexico (Chapter 4), where accounting is like that in common law countries.

[4] Irving Fantl, "The Case Against International Uniformity," *Management Accounting* (May 1971): 13–16.

not incorporated directly into statute law.[5] Code law accounting tends to focus on legal form, whereas common law accounting tends to focus on economic substance. For example, leases are normally not capitalized under code law. In contrast, under common law leases are capitalized when they are, in substance, the purchase of property. Exhibit 2-1 lists code and common law countries.

3. ***Taxation*** In many countries, tax legislation effectively determines accounting standards because companies must record revenues and expenses in their accounts to claim them for tax purposes. In other words, financial and tax accounting are the same. This is the case, for example, in Germany and Sweden.

EXHIBIT 2-1 Code and Common Law Countries

Code law—French origin

Africa
Egypt

Americas
Argentina
Brazil
Chile
Colombia
Ecuador
Mexico
Peru
Uruguay
Venezuela

Asia
Indonesia
Jordan
Philippines
Turkey

Europe
Belgium
France
Greece
Italy
Luxembourg
The Netherlands
Portugal
Spain

Code law—German origin

Asia
Japan
South Korea
Taiwan

Europe
Austria
Czech Republic
Germany
Hungary
Slovak Republic
Switzerland

Code law—Scandinavian origin

Europe
Denmark
Finland
Iceland
Norway
Sweden

Common law

Africa
Kenya
Nigeria
South Africa
Zimbabwe

Americas
Canada
United States

Asia
Hong Kong
India
Israel
Malaysia
Pakistan
Singapore
Sri Lanka
Thailand

Australasia
Australia
New Zealand

Europe
Ireland
United Kingdom

Source: Adapted from Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Law and Finance," *Journal of Political Economy* 106, No. 6 (1998): 1142–1143; and David Alexander and Simon Archer, *European Accounting Guide,* 5th ed., New York: Aspen, 2003.

[5] Under martial law or other national emergency situations, all aspects of the accounting function may be regulated by a central governmental court or agency. This was the case, for instance, in Nazi Germany, where intensive war preparations and World War II itself required a highly uniform national accounting system for total control of all national economic activities.

In other countries, such as the Netherlands, financial and tax accounting are separate: Taxable profits are essentially financial accounting profits adjusted for differences with the tax laws. Of course, even where financial and tax accounting are separate, tax legislation may occasionally require the application of certain accounting principles. Last in, first out (LIFO) inventory valuation in the United States is an example.

4. ***Political and Economic Ties*** Accounting ideas and technologies are transferred through conquest, commerce, and similar forces. Double-entry bookkeeping, which originated in Italy in the 1400s, gradually spread across Europe along with other ideas of the Renaissance. British colonialism exported accountants and accounting concepts throughout the empire. German occupation during World War II led France to adopt its Plan Comptable (see Chapter 3). The United States imposed U.S.-style accounting regulatory regimes on Japan after World War II. Many developing economies use an accounting system that was developed elsewhere, either because it was imposed on them (e.g., India) or by their own choice (e.g., countries of Eastern Europe that modeled their accounting systems after European Union [EU] regulations). As discussed more generally in Chapter 8, economic integration through the growth of international trade and capital flows is a powerful motivator for the convergence of accounting standards in countries around the world.
5. ***Inflation*** Inflation distorts historical cost accounting by understating asset values and related expenses, and overstating income. Countries with high inflation often require that companies incorporate price changes into the accounts. For example, Mexico applies general price-level accounting when its cumulative three-year inflation rate equals or exceeds 28 percent (an annual average compounded rate of 8 percent).[6] In the late 1970s, in response to unusually high rates of inflation, both the United States and the United Kingdom experimented with reporting the effects of changing prices. Accounting responses to inflation are explored in Chapter 7.
6. ***Level of Economic Development*** This factor affects the types of business transactions conducted in an economy and determines which ones are most prevalent. The type of transactions, in turn, determines the accounting issues that are faced. For example, stock-based executive compensation or asset securitization makes little sense in economies with underdeveloped capital markets. Today, many industrial economies are becoming service economies. Accounting issues relevant in manufacturing, such as valuing fixed assets and recording depreciation, are becoming less important. New accounting challenges, such as valuing intangibles and human resources, are emerging.
7. ***Educational Level*** Highly sophisticated accounting standards and practices are useless if they are misunderstood and misused. For example, a complex technical report on cost behavior variances is meaningless unless the reader understands cost accounting. Disclosures about the risks of derivative securities are not informative unless they can be read competently. Professional accounting education is difficult to achieve where general educational levels are low. Mexico is a country

[6] Israel discontinued inflation-adjusted accounting in 2004 after drastic reductions in inflation.

where this difficulty has been overcome. In other situations, a country must import accounting training or send its citizens elsewhere to get it, something that China is now doing. (Mexico and China are discussed in Chapter 4.)

Several of these first seven variables are closely associated. For example, the common law legal systoem originated in Britain and was exported to such countries as Australia, Canada, and the United States. These four countries all have highly developed capital markets that dominate the orientation of their financial reporting. Financial and tax accounting are separate. By contrast, most of continental Europe and Japan have code law legal systems and rely on banks or the government for most of their finance. Thus, their accounting rules generally conform to tax laws. Establishing cause and effect is difficult. The type of legal system may predispose a country toward its system of finance. A common law legal system emphasizes shareholder rights and offers stronger investor protection than a code law system. The outcome is that strong equity markets develop in common law countries and weak ones develop in code law countries.[7] Taxation is an important function of accounting in any country with a corporate income tax. Whether it dominates the orientation of accounting may depend on whether accounting has a major competing purpose, namely, informing outside shareholders. (Tax accounting is not suitable for this purpose.) If common law results in strong equity markets, taxation will not dominate. There will be two sets of accounting rules: one for taxation and another for financial reporting. Tax rules will dominate in code law/credit-based countries, and accounting for taxation and financial reporting will be the same.[8] Two basic orientations of accounting have evolved out of these circumstances. One is oriented toward a fair presentation of financial position and results of operations; the other is designed to comply with legal requirements and tax law. The *fair presentation* versus *legal compliance* distinction is further discussed at the end of the chapter.

8. ***Culture*** Culture encompasses the values and attitudes shared by a society. Cultural variables underlie nations' legal systems and other institutional arrangements. Hofstede identified four national cultural dimensions (or societal values): (1) individualism, (2) uncertainty avoidance, (3) power distance, and (4) masculinity. His analysis is based on data from employees of a large U.S. multinational corporation operating in 40 different countries.[9]

Briefly, *individualism* (versus *collectivism*) is a preference for a loosely knit social fabric over an interdependent, tightly knit fabric (*I* versus *we*). *Uncertainty avoidance* is the degree to which society is uncomfortable with ambiguity and an uncertain future. *Power distance* is the extent to which hierarchy and an unequal distribution of power in institutions and organizations are accepted. *Masculinity* (versus *femininity*) is the extent to which gender roles are differentiated and performance and visible achievement (traditional masculine values)

[7] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R.W. Vishny, "Legal Determinants of External Finance," *Journal of Finance* (July 1997): 1131–1150.
[8] C. Nobes, "Towards a General Model of the Reasons for International Differences in Financial Reporting," *Abacus* (September 1998): 162–187.
[9] G. Hofstede, *Culture's Consequences: International Differences in Work-Related Values* (Beverly Hills, CA: Sage Publications, 1980).

are emphasized over relationships and caring (traditional feminine values). Some scholars now call this *achievement orientation*.[10]

Drawing on Hofstede's analysis, Gray proposed a framework linking culture and accounting.[11] He suggests that four *accounting value dimensions* affect a nation's financial reporting practices. They are:

1. Professionalism vs. statutory control: a preference for the exercise of individual professional judgment and professional self-regulation, as opposed to compliance with prescriptive legal requirements.

> A preference for independent professional judgment is consistent with a preference for a loosely knit social framework where there is more emphasis on independence, a belief in fair play and as few rules as possible, and where a variety of professional judgments will tend to be more easily tolerated. . . . [P]rofessionalism is more likely to be accepted in a small power-distance society where there is more concern for equal rights, where people at various power levels feel less threatened and more prepared to trust people, and where there is a belief in the need to justify the imposition of laws and codes.[12]

2. Uniformity vs. flexibility: a preference for uniformity and consistency over flexibility in reacting to circumstances.

> A preference for uniformity is consistent with a preference for strong uncertainty avoidance leading to a concern for law and order and rigid codes of behaviour, a need for written rules and regulations, a respect for conformity and the search for ultimate, absolute truths and values. [Uniformity] is also consistent with a preference for collectivism . . . with its tightly knit social framework, a belief in organization and order, and respect for group norms. . . . [U]niformity is more easily facilitated in a large power-distance society in that the imposition of laws and codes of a uniform character are [*sic*] more likely to be accepted.[13]

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[10] Later work documents a fifth cultural dimension, *Confucian dynamism* (also called *long-term orientation*). This later work contends that only individualism, power distance, and masculinity are universal across all cultures. Uncertainty avoidance is a unique characteristic of Western societies, whereas Confucian dynamism is unique to Eastern societies. See G. Hofstede and M.H. Bond, "The Confucian Connection: From Cultural Roots to Economic Growth," *Organizational Dynamics* 16, No. 1 (1988): 4–21; G. Hofstede, *Cultures and Organizations: Softwares of the Mind* (London: McGraw-Hill, 1991). The existence of this fifth dimension has been contested. See R. Yeh and J.J. Lawrence, "Individualism and Confucian Dynamism: A Note on Hofstede's Cultural Root to Economic Growth," *Journal of International Business Studies* (third quarter 1995): 655–669. These authors note a data problem in Hofstede's subsequent work. Once an outlier is removed, Confucian dynamism no longer emerges as an independent construct; it reflects the same cultural dimension as individualism. It should also be pointed out that there are other cultural dimensions that are not considered by Hofstede. For example, religion, which extends beyond national boundaries, underlies business practices, institutional arrangements, and, by extension, accounting. Language is another cultural input. For a critique of Hofstede, see B. McSweeney, "Hofstede's Model of National Cultural Differences and Their Consequences," *Human Relations* (January 2002): 89–118.

[11] S. J. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally," *Abacus* (March 1988): 1–15.

[12] Ibid., 9.

[13] Ibid., 9–10.

3. **Conservatism vs. optimism:** a preference for a cautious approach to measurement to cope with the uncertainty of future events instead of a more optimistic, risk-taking approach.

> A preference for more conservative measures of profits is consistent with strong uncertainty avoidance following from a concern with security and a perceived need to adopt a cautious approach to cope with uncertainty of future events. . . . [A]n emphasis on individual achievement and performance is likely to foster a less conservative approach to measurement.[14]

4. **Secrecy vs. transparency:** a preference for confidentiality and the restriction of business information on a need-to-know basis versus a willingness to disclose information to the public.

> A preference for secrecy is consistent with strong uncertainty avoidance following from a need to restrict information disclosures so as to avoid conflict and competition and to preserve security. . . . [H]igh power-distance societies are likely to be characterized by the restriction of information to preserve power inequalities. Secrecy is also consistent with a preference for collectivism . . . with its concern for those closely involved with the firm rather than external parties. . . . [S]ocieties where more emphasis is given to the quality of life, people, and the environment, will tend to be more open especially as regards socially related information.[15]

Exhibit 2-2 shows how Gray's accounting values relate to Hofstede's cultural dimensions.[16]

EXHIBIT 2-2 Relationships Between Accounting Values and Cultural Dimensions

	Accounting Values			
Cultural Dimensions	Professionalism	Uniformity	Conservatism	Secrecy
Individualism	+	–	–	–
Uncertainty Avoidance	–	+	+	+
Power Distance	–	+	•	+
Masculinity	•	•	–	–

Note: + indicates a direct relationship between the variables; – indicates an inverse relationship; • indicates no relationship. Gray hypothesizes that individualism and uncertainty avoidance will influence accounting the most, followed by power distance, then masculinity.

[14] Ibid., 10.
[15] Ibid., 11.
[16] The empirical work testing Gray's framework is reviewed in T.S. Doupnik and G. T. Tsakumin, "A Critical Review of Gray's Theory of Cultural Relevance and Suggestions for Future Research," *Journal of Accounting Literature* 23 (2004): 1–48.

CLASSIFICATION

International accounting classifications fall into two categories: judgmental and empirical. Judgmental classifications rely on knowledge, intuition, and experience.[17] Empirically derived classifications apply statistical methods to databases of accounting principles and practices around the world.[18]

Four Approaches to Accounting Development[19]

The pioneering classification is the one proposed by Mueller in the mid-1960s. He identified four approaches to accounting development in Western nations with market-oriented economic systems. (1) Under the *macroeconomic* approach, accounting practices are derived from and designed to enhance national macroeconomic goals. Firm goals normally follow rather than lead national economic policies as business firms coordinate their activities with national policies. Thus, for example, a national policy to maintain stable employment by avoiding big swings in business cycles would result in accounting practices that smooth income. As another example, a nation that wished to promote the development of certain industries could permit them to rapidly write off capital expenditures. Accounting in Sweden developed from the macroeconomic approach. (2) Under the *microeconomic* approach, accounting develops from the principles of microeconomics. The focus is on individual firms whose main goal is to survive. To accomplish this goal, firms must maintain their physical capital. It is also critical that they clearly separate capital from income to evaluate and control their business activities. Accounting measurements based on replacement cost best fit this approach. Accounting developed from microeconomics in the Netherlands. (3) Under the *independent discipline* approach, accounting derives from business practices and develops on an ad hoc, piecemeal basis from judgment and trial-and-error. Accounting is viewed as a service function that derives its concepts and principles from the business process it serves, not from a discipline such as economics. Businesses cope with real-world complexities and ever-present uncertainties through experience, practice, and intuition. Accounting develops the same way. For example, income is simply what seems to be the most useful in practice, and disclosures respond pragmatically to user needs. Accounting developed as an independent discipline in the United Kingdom and the United States. (4) Under the *uniform* approach, accounting is standardized by the central government and employed as a tool for administrative control. Uniformity in measurement, disclosure, and presentation makes it easier for government planners, tax authorities, and even managers to use accounting information to control all types of businesses. In general, the uniform approach is used in

[17] Examples are C. W. Nobes, "A Judgmental International Classification of Financial Reporting Practices," *Journal of Business Finance & Accounting* (spring 1983): 1–19; idem, "Towards a General Model of the Reasons for International Differences in Financial Reporting," *Abacus* (September 1998): 162–187.

[18] Examples are R. D. Nair and W. G. Frank, "The Impact of Disclosure and Measurement Practices on International Accounting Classifications," *Accounting Review* (July 1980): 426–450; T. S. Doupnik and S. B. Salter, "External Environment, Culture, and Accounting Practice: A Preliminary Test of a General Model of International Accounting Development," *International Journal of Accounting* 30, No. 3 (1995): 189–207.

[19] The concepts underlying these developmental patterns were first proposed in G. Mueller, *International Accounting* (New York: Macmillan, 1967). This work is the basis for most of the classifications of accounting systems worldwide.

countries with strong governmental involvement in economic planning where accounting is used to measure performance, allocate resources, collect taxes, and control prices, among other things. France, with its national uniform chart of accounts, is the leading exponent of the uniform approach.[20]

Legal Systems: Common Law vs. Code Law Accounting

Accounting can also be classified by a nation's legal system.[21] This view has dominated accounting thinking for the last 25 years or so. (1) Accounting in *common law* countries is characterized as oriented toward "fair presentation," transparency and full disclosure, and a separation between financial and tax accounting. Stock markets dominate as a source of finance, and financial reporting is aimed at the information needs of outside investors. Setting accounting standards tends to be a private sector activity, and the accounting profession plays an important role. Common law accounting is often called "Anglo-Saxon," "British-American," or "micro-based." Common law accounting originated in Britain and was exported to such countries as Australia, Canada, Hong Kong, India, Malaysia, Pakistan, and the United States. (2) Accounting in *code law* countries is characterized as legalistic in orientation, opaque with low disclosure, and an alignment between financial and tax accounting. Banks or governments ("insiders") dominate as a source of finance, and financial reporting is aimed at creditor protection. Setting accounting standards tends to be a public sector activity, with relatively less influence by the accounting profession. Code law accounting is often called "continental," "legalistic," or "macro-uniform." It is found in most of the countries of continental Europe and their former colonies in Africa, Asia, and the Americas.

This characterization of accounting parallels the so-called stockholder and stakeholder models of corporate governance in common and code law countries, respectively. As noted earlier in this chapter, a nation's legal system and its system of finance may be linked in a cause-and-effect way.[22] A common law legal system emphasizes shareholder rights and offers stronger investor protection than a code law system. Laws protect outside investors and are generally well enforced. The outcome is that strong capital markets develop in common law countries and weak ones develop in code law countries. Relative to code law countries, firms in common law countries raise substantial amounts of capital through public offerings to numerous outside

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[20] European academics like K. Käfer (Switzerland), L. L. Illetschko (Austria), E. Schmalenbach (Germany), and A. ter Vehn (Sweden) are largely identified with generalizing accounting processes from comprehensive charts of accounts.

[21] See, for example, C. W. Nobes, "A Judgmental International Classification of Financial Reporting Practices," *Journal of Business Finance & Accounting* (spring 1983): 1–19; I. Berry, "The Need to Classify Worldwide Accountancy Practices," *Accountancy* (October 1987): 90–91; T. S. Doupnik and S. B. Salter, "An Empirical Test of a Judgmental International Classification of Financial Reporting Practices," *Journal of International Business Studies* 24, No. 1 (1993): 41–60.; R. Ball, S. P. Kothari, and A. Robin, "The Effect of International Institutional Factors on Properties of Accounting Earnings," *Journal of Accounting and Economics* 29, No. 1 (2000): 1–51.

[22] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R.W. Vishny, "Legal Determinants of External Finance," *Journal of Finance* (July 1997): 1131–1150; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R.W. Vishny, "Law and Finance," *Journal of Political Economy* 106, No. 6 (December 1998): 1113–1155; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics* 58, Nos. 1–2 (2000): 3–27.

investors. Because investors are at arm's length to the firm, there is a demand for accounting information that accurately reflects the firm's operating performance and financial position. Public disclosure resolves the information asymmetry between the firm and investors.

By contrast, ownership of firms in code law countries tends to be concentrated in the hands of families, other corporations, and large commercial banks. Firms satisfy substantial fractions of their capital needs from the government or through bank borrowing. Debt as a source of finance is relatively more important in code law countries than in common law countries. Conservative accounting measurements provide a cushion to lenders in the event of default. Major lenders and significant equity investors may occupy seats on boards of directors, along with other stakeholders, such as labor and important suppliers and customers. Because information demands are satisfied by private communication, there is less demand for public disclosure. Accounting income is the basis for income taxes owed and often, as well, for dividends and employee bonuses, resulting in pressures for smooth income amounts from year to year.

Practice Systems: Fair Presentation vs. Legal Compliance Accounting

Many accounting distinctions at the national level are becoming blurred. There are several reasons for this. (1) The importance of stock markets as a source of finance is growing around the world. Capital is increasingly global, creating pressure for a world standard of corporate reporting. For many companies, global convergence of financial reporting standards will reduce the costs of complying with different accounting rules and may also reduce their costs of capital. The integration of the world's capital markets is arguably the most important reason why the International Accounting Standards Board has emerged as the focal point for accounting standard setting in Australia, Japan, Europe, Singapore, South Africa, the United States, and elsewhere (see Chapter 8). Stock market development is also a top priority in many countries, especially those emerging from centrally planned to market-oriented economies. Two such countries are the Czech Republic and China, discussed in Chapters 3 and 4, respectively. (2) Dual financial reporting is becoming more common. One set of financial statements complies with local, domestic financial reporting requirements, while the other set uses accounting principles and contains disclosures aimed at international investors. Starting in 2005, all European listed companies were required to adopt International Financial Reporting Standards in their consolidated financial statements.[23] However, some EU code law countries, such as France and Germany, sanctioned a duality whereby individual company financial statements comply with national legal standards and consolidated financial statements comply with IFRS. In other words, it is necessary to distinguish accounting practice at the *national* level from that at the *transnational* level. (3) Some code law countries, in particular Germany and Japan (Chapters 3 and 4, respectively), are shifting responsibility for setting accounting standards from the government to independent professional, private-sector groups. This change makes the standard-setting process more like that in common law countries such as Australia, Canada, the United Kingdom, and the United States, and is

[23] Approximately 8,000 companies are affected by this requirement.

seen as a way to more actively influence the agenda of the IASB. These points indicate that another framework besides legal systems is needed to classify accounting worldwide.[24]

We believe that a classification based on *fair presentation* versus *legal compliance* describes accounting in the world today.[25] The distinction between fair presentation and legal compliance has pervasive effects on many accounting issues, such as (1) depreciation, where the expense is determined based on the decline in an asset's usefulness over its economic useful life (fair presentation) or the amount allowed for tax purposes (legal compliance); (2) leases that are in substance a purchase of property are treated as such (fair presentation) or are treated like regular operating leases (legal compliance); and (3) pensions with costs accrued as earned by employees (fair presentation) or expensed on a pay-as-you-go basis (legal compliance). In addition, the issue of deferred income taxes never arises when tax and financial accounting are the same.

Another issue is the use of discretionary reserves to smooth income from one period to the next. Generally, these reserves work the following way. In good years extra expenses are provided for, with the corresponding credit going to a reserve account in shareholders' equity. In lean years reserves are dissolved to boost income. This process irons out year-to-year fluctuations in income. Because this practice jeopardizes a fair presentation, it is less common under fair presentation and more common under legal compliance. Of course, if such manipulations are fully disclosed, investors can undo the effects on income. This may not be the case; reserves often are secret.

Fair presentation and *substance over form* characterize common law accounting described above. It is oriented toward the decision needs of external investors. Financial statements are designed to help investors judge managerial performance and predict future cash flows and profitability. Extensive disclosures provide additional information relevant for these purposes. IFRS are also aimed at fair presentation. IFRS are particularly relevant for companies relying on international capital markets for finance. Fair presentation accounting is found in the United Kingdom, the United States, the Netherlands, and other countries influenced by political and economic ties to them (such as British influence throughout the former British Empire and U.S. influence on

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[24] The common law vs. code law distinction can be criticized on other grounds. First, there are exceptions. The Netherlands (Chapter 3) and Mexico (Chapter 4) are code law countries with fair presentation accounting. Some observers doubt that legal systems are the sole cause of differences in accounting systems worldwide, but one of several contributing factors, including sources of finance and colonial or cultural influence. They say that there are too many exceptions for causality to run from legal system to accounting system. See, in particular, C. Nobes and A. Roberts, "Towards a Unifying Model of Systems of Law, Corporate Financing, Accounting and Corporate Governance," *Australian Accounting Review* 10, No. 1 (2000): 26–34. Enforcement is another significant point. If laws and accounting standards are not enforced, they exist on paper only. Distinctions based on legal systems are less clear in countries where standards are not enforced. See C. Leuz, D. Nanda, and P. Wysocki, "Investor Protection and Earnings Management: An International Comparison," *Journal of Financial Economics* (September 2003): 505–527.

[25] For completeness, *inflation-adjusted* accounting should also be considered. Accounting in Mexico is fair presentation with general price level accounting added on when inflation is high. (Chapter 4 discusses accounting in Mexico.) Countries also abandon inflation adjustments once inflation is tamed, as happened in Brazil and Israel. Islamic accounting, which has a theological base, is also omitted from this framework. It prohibits recognizing interest on money, and current market values are favored as measures of assets and liabilities. Islamic accounting has not yet evolved to the point where it represents a comprehensive pattern of accounting.

Canada, Mexico, and the Philippines). All listed European companies follow fair presentation accounting in their consolidated statements since they now use IFRS. Further, IFRS are the benchmark for standards now being developed in China and Japan (Chapter 4).

Legal compliance 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 managers and employees. Conservative measurements ensure that prudent amounts are distributed. Smooth patterns in income from year to year mean that tax, dividend, and bonus payouts are more stable. Legal compliance accounting will probably continue to be used in individual-company financial statements in those code law countries where consolidated statements adopt fair presentation reporting. In this way, consolidated statements can inform investors while individual-company accounts satisfy legal requirements.

We believe that the integration of the world's capital markets will be the most significant influence shaping accounting development in the future. This development is the reason behind the trend toward fair presentation accounting, at least for consolidated financial statements. It is also the key driver behind the activities of the International Accounting Standards Board and the European Union's "IFRS 2005" decision, and it is why financial statement analysis is increasingly global in nature.

Discussion Questions

1. The chapter identifies seven economic, sociohistorical, and institutional factors believed to influence accounting development. Explain how each one affects accounting practice.
2. How do cultural values influence accounting? Are there parallel influences between the factors identified in Question 1 and the cultural factors identified here?
3. Are national differences in accounting practice better explained by culture or by economic and legal factors? Why?
4. The four approaches to accounting development discussed in the chapter were originally outlined in 1967. Do you think these patterns will persist in the future? Why or why not?
5. Countries that have relatively conservative measurement practices also tend to be secretive in disclosure, while countries that have less conservative measurement practices tend to be transparent in disclosure. Why is this so?
6. What is the purpose of classifying systems of accounting? What is the difference between a judgmental and an empirical classification of accounting?
7. What are the major accounting classifications in the world? What are the distinguishing features of each model?
8. Why does the chapter contend that many accounting distinctions at the national level are becoming blurred? Do you agree? Why or why not?
9. The authors contend that a classification based on fair presentation vs. legal compliance describes accounting in the world today better than one based on common law and code law legal systems. Do you agree? Why or why not?
10. What are the prospects of a convergence or harmonization of national systems of accounting and financial reporting? What factors might be influential in promoting or inhibiting change?

Exercises

1. The chapter identifies seven economic, historical, and/or institutional variables that influence accounting development: sources of finance, legal system, taxation, political and economic ties, inflation, level of economic development, and education level.

   Required:
   a. Consider the case of Taiwan. Describe it on the basis of these seven dimensions. Web sites include the *Encyclopaedia Britannica Online* (www.eb.com) and *The World Factbook* (www.cia.gov/library/publications/the-world-factbook).
   b. Using this description, predict a general profile of financial accounting in Taiwan.
   c. Go to the library and find a reference that describes accounting in Taiwan. Is your prediction accurate? Why or why not?

2. Consider the following countries: (1) Belgium, (2) China, (3) the Czech Republic, (4) Gambia, (5) India, (6) Mexico, (7) Senegal, and (8) Taiwan.

   Required: Where would they be classified based on legal system? Where would they be classified based on accounting practice systems? Justify your answers. (*Hint:* Web sites with information on countries of the world include the *Encyclopaedia Britannica Online* (www.eb.com) and *The World Factbook* (www.cia.gov/ library/publications/the-world-factbook).)

3. Go to the World Federation of Exchanges Web site (www.world-exchanges.org) and obtain the latest annual report. The market statistics section on equity markets has information on the numbers of domestic and foreign companies listed on member stock exchanges.

   Required: Which five stock exchanges have the most foreign listed companies? Which five stock exchanges have the highest proportion of foreign to total listed companies? Discuss possible reasons for this.

4. The European Union (EU)—formerly known as the European Community and, at its start, as the European Common Market—was founded in 1957 and had 15 members at the end of 2003: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. To encourage capital movement and capital formation, the EU has issued various *Directives* designed to harmonize the generally accepted accounting principles of its member countries.

   Required: Which of the factors affecting accounting development are likely to be the most serious obstacles to the EU harmonization effort? What factors indicate that the EU harmonization effort can succeed?

5. Refer to Exercise 4. In May 2004, the EU expanded to incorporate 10 Central and East European nations: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Bulgaria and Romania joined in January 2007.

   Required: Which factors affecting accounting development are likely to be the most serious obstacles to achieving accounting harmonization with the other 15 member nations?

6. Gray proposed a framework linking culture and accounting. He predicts four accounting values (professionalism, uniformity, conservatism, and secrecy) based on Hofstede's four cultural dimensions (individualism, uncertainty avoidance, power distance, and masculinity). Exhibit 2-2 has Gray's predictions and also notes that individualism and uncertainty avoidance are expected to have the most significant influence on accounting values.

   Required:
   a. Go to Hofstede's Web site (www.geert-hofstede.com/hofstede_dimensions.php) and find the individualism scores for the following 10 countries: China, the Czech Republic, France, Germany, India, Japan, Mexico, the Netherlands, the United Kingdom, and the United States.
   b. Characterize the individualism scores as high, medium, or low.
   c. Based on your characterizations in the preceding item, predict Gray's four accounting values for the 10 countries.

7. Refer to Exercise 6.

Required:

a. Go to Hofstede's Web site (www.geert-hofstede.com/hofstede_dimensions. php) and find the uncertainty avoidance scores for the same 10 countries.

b. Characterize the uncertainty avoidance scores as high, medium, or low.

c. Based on your characterizations in the preceding items, predict Gray's four accounting values for the 10 countries.

d. Are these predictions consistent with those in Exercise 6?

8. Many countries permit or require their domestic listed companies to use International Financial Reporting Standards (IFRS) in their consolidated financial statements for investor reporting.

Required: Consider the following 10 countries: China, the Czech Republic, France, Germany, India, Japan, Mexico, the Netherlands, the United Kingdom, and the United States. For which countries are IFRS (a) not permitted, (b) permitted, (c) required for some, or (d) required for all domestic listed companies? Discuss the possible reasons for the observed patterns. (*Hint:* Refer to the IAS Plus Web site, www.iasplus.com.)

9. Consider the development factors in the following five countries: France, India, Japan, the United States, and the United Kingdom:

Development Factor	France	India	Japan	United Kingdom	United States
Main source of finance	Banks; government	Government; Stock market	Banks	Stock market	Stock market
Legal system	Code law	Common law	Code law	Common law	Common law
Taxation (link to accounting)	Linked	Separate	Linked	Separate	Separate
Political and economic ties	Europe	U.K., U.S., China	U.S., China	U.S., Europe	Canada, Mexico
Inflation	Low	Low	Low	Low	Low
Level of economic development	High	Low	High	High	High
Educational level	High	Low	High	High	High

Required: Based on the information provided in this chapter, prepare a profile of accounting in each of the countries.

10. Think ahead 10 years from now. Prepare a classification of accounting systems that you think will exist then. What factors motivate your classification?

CASES

Case 2-1

Are Classifications of Accounting Outmoded?

Consider the following statements by David Cairns, former secretary-general of the International Accounting Standards Committee.[26]

> When we look at the way that countries or companies account for particular transactions and events, it is increasingly difficult to distinguish in a systematic way so-called Anglo-American accounting from Continental European accounting or American accounting from, say, German accounting.[27]
>
> I am increasingly persuaded . . . that the distinction between Anglo-American accounting and Continental European accounting is becoming less and less relevant and more and more confused. In reaching this conclusion, I do not dispute that different economic, social and legal considerations have influenced the development of accounting in different countries. I also do not dispute the fact that there have been, and still are, differences in the means by which different countries determine accounting requirements and the form of the resulting requirements. I do believe, however, that those who continue to favour these classifications are ignoring what is happening in the world and how companies actually account for transactions and events.
>
> It is increasingly apparent that the different economic, social and legal considerations which have influenced national accounting do not necessarily result in different accounting and that countries are reaching the same answers irrespective of their different cultural backgrounds (or reaching different answers in spite of the similar cultural backgrounds). In fact, there are now probably far more similarities between American and German accounting than there are between American and British accounting. There are many reasons for this not least the increasing practice of standard setting bodies and other regulators to share ideas and learn from one another. They do this in the IASC, the UN, the OECD, the EU, and such groupings as G4. This cross-fertilization of ideas is not surprising because standard setting bodies in all countries are having to address the same accounting problems.[28]

Required

1. Do you agree with Cairns's assertion that classifications of accounting are simplistic and of little

[26] D. Cairns, "The Future Shape of Harmonization: A Reply," *European Accounting Review* 6, No. 2 (1997): 305–348.
[27] Ibid., 306.
[28] Ibid., 316.

relevance in today's world? Are attempts to classify accounting futile and outmoded? Why or why not?

2. Some observers contend that financial reporting is becoming more and more alike among "world-class" companies—the world's largest multinational corporations—and especially those listed on the major stock exchanges, such as London, New York, and Tokyo. What is the relevance of this contention for classifications of accounting, and what are the factors that would cause this to happen?

Case 2-2

Volkswagen Group

The Volkswagen Group adopted International Accounting Standards (IAS, now International Financial Reporting, or IFRS) for its 2001 fiscal year. The following is taken from Volkswagen's 2001 annual report. It discusses major differences between the German Commercial Code (HGB) and IAS as they apply to Volkswagen.

General

In 2001 VOLKSWAGEN AG has for the first time published its consolidated financial statements in accordance with International Accounting Standards (IAS) and the interpretations of the Standing Interpretations Committee (SIC). All mandatory International Accounting Standards applicable to the financial year 2001 were complied with. The previous year's figures are also based on those standards. IAS 12 (revised 2000) and IAS 39, in particular, were already complied with in the year 2000 consolidated financial statements. The financial statements thus give a true and fair view of the net assets, financial position and earning performance of the Volkswagen Group.

The consolidated financial statements were drawn up in Euros. Unless otherwise stated, all amounts are quoted in millions of Euros (million €).

The income statement was produced in accordance with the internationally accepted cost of sales method.

Preparation of the consolidated financial statements in accordance with IAS requires assumptions regarding a number of line items that affect the amounts entered in the consolidated balance sheet and income statement as well as the disclosure of contingent assets and liabilities.

The conditions laid down in Section 292a of the German Commercial Code (HGB) for exemption from the obligation to draw up consolidated financial statements in accordance with German commercial law are met. Assessment of the said conditions is based on German Accounting Standard No. 1 (DSR 1) published by the German Accounting Standards Committee.

In order to ensure equivalence with consolidated financial statements produced in accordance with German commercial law, all disclosures and explanatory notes required by German commercial law beyond the scope of those required by IAS are published.

Transition to International Accounting Standards

The accounting valuation and consolidation methods previously applied in the financial statements of VOLKSWAGEN AG as produced in accordance with the German Commercial Code have been amended in certain cases by the application of IAS.

Amended accounting, valuation and consolidation methods in accordance with the German Commercial Code

- Tangible assets leased under finance leases are capitalized, and the corresponding liability is recognized under liabilities in the balance sheet, provided the risks and rewards of ownership are substantially attributable to the companies of the Volkswagen Group in accordance with IAS 17.
- As a finance lease lessor, leased assets are not capitalized, but the discounted leasing installments are shown as receivables.
- Movable tangible assets are depreciated using the straight-line method instead of the declining balance method; no half-year or multi-shift depreciation is used. Furthermore, useful lives are now based on commercial substance and no longer on tax law. Special depreciation for tax reasons is not permitted with IAS.
- Goodwill from capital consolidation resulting from acquisition of companies since 1995 is capitalized in accordance with IAS 22 and amortized over its respective useful life.
- In accordance with IAS 2, inventories must be valued at full cost. They were formerly capitalized only at direct cost within the Volkswagen Group.
- Provisions are only created where obligations to third parties exist.
- Differences from the translation of financial statements produced in foreign currencies are not recorded in the income statement.
- Medium- and long-term liabilities are entered in the balance sheet including capital take-up costs, applying the effective interest method.

Amended accounting, valuation and consolidation methods that differ from the German Commercial Code

- In accordance with IAS 38, development costs are capitalized as intangible assets provided it is likely that the manufacture of the developed products will be of future economic benefit to the Volkswagen Group.
- Pension provisions are determined according to the Projected Unit Credit Method as set out in IAS 19, taking account of future salary and pension increases.
- Provisions for deferred maintenance may not be created.
- Medium- and long-term provisions are shown at their present value.
- Securities are recorded at their fair value, even if this exceeds cost, with the corresponding effect in the income statement.
- Deferred taxes are determined according to the balance sheet

liability method. For losses carried forward deferred tax assets are recognized, provided it is likely that they will be usable.

- Derivative financial instruments are recognized at their fair value, even if it exceeds cost. Gains and losses arising from the valuation of financial instruments serving to hedge future cash flows are recognized by way of a special reserve in equity. The profit or loss from such contracts is not recorded in the income statement until the corresponding due date. In contrast, gains and losses arising from the valuation of derivative financial instruments used to hedge balance sheet items are recorded in the income statement immediately.
- Treasury shares are offset against capital and reserves.
- Receivables and payables denominated in foreign currencies are valued at the middle rate on the balance sheet date, and not according to the imparity principle.
- Minority interests of shareholders from outside the Group are shown separately from capital and reserves.

The adjustment of the accounting and valuation policies to International Accounting Standards with effect from January 1, 2000 was undertaken in accordance with SIC 8, with no entry in the income statement, as an allocation to or withdrawal from revenue reserves, as if the accounts had always been produced in accordance with IAS.

The reconciliation of the capital and reserves to IAS in shown in the following table:

	million €
Capital and reserves according to the German Commercial Code as at January 1, 2000	**9,811**
Capitalization of development costs	3,982
Amended useful lives and depreciation methods in respect of tangible and intangible assets	3,483
Capitalization of overheads in inventories	653
Different treatments of leasing contracts as lessor	1,962
Differing valuation of financial instruments	897
Effect of deferred taxes	−1,345
Elimination of special items	262
Amended valuation of pension and similar obligations	−633
Amended accounting treatment of provisions	2,022
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**

Source: Volkswagen AG Annual Report 2001, pp. 84–86.

Required

1. Based on the information provided in the chapter, describe the basic features of German accounting at the time Volkswagen adopted IAS. What developmental factors cause these features?
2. What differences between the accounting requirements in the HGB and IAS are highlighted in Volkswagen's disclosure? Are the German requirements consistent with your characterizations in requirement 1?
3. What is the relevance of Volkswagen's adoption of IAS to the classifications studied in this chapter?