CHAPTER 4

Comparative Accounting: The Americas and Asia

Chapter 4 looks at accounting in five countries, two in the Americas (Mexico and the United States) and three in Asia (China, India, and Japan). The United States and Japan have highly developed economies, whereas Mexico, China, and India are "emerging" economies.[1] The United States is the largest economy in the world and home to more large multinational corporations than any other nation. Japan has the second biggest economy in the world and is also home to many of the world's largest businesses. Both countries were founders of the International Accounting Standards Committee (now the International Accounting Standards Board, or IASB), and they have a major role in directing the IASB's agenda.

Why were the other countries chosen for this chapter? We picked Mexico because we wanted to include a Latin American country. Free-market reforms accelerated in the 1990s throughout much of Latin America. These reforms involved removing protectionist barriers to imports, welcoming foreign investment, and privatizing state-owned companies. The 1994 North American Free Trade Agreement (NAFTA) created much new interest in Mexican accounting in Canada, the United States, and elsewhere. Accounting in Mexico has many features in common with accounting in other Latin American countries. The choice of China may be obvious: It is the largest and most populous country in the world. Companies from all around the world are eager to do business there. Like the Czech Republic, discussed in Chapter 3, China is converting from a centrally planned economy to one that is more market oriented. However, the extent to which these two countries are embracing market reforms is different. The Czech Republic is moving toward a complete market economy, while China is taking a middle course in moving to

[1] As noted in Chapter 3, the term "emerging economy" refers loosely to newly industrialized countries (NICs) and to countries in transition from planned to free-market economies. NICs have experienced rapid industrial growth, but their economies are not yet rich in terms of per capita gross domestic product. Mexico and India are NICs; China has an economy in transition.

a *socialist market economy*, that is, a planned economy with market adaptations. Accounting developments are an important part of the structural changes in the Chinese economy. India, the second most populous country in the world, has been described as "the next big thing. . . . No big international company can do without an India strategy."[2] Reforms that began in 1991 have resulted in a remarkable transformation of its economy, and most observers feel that the next decade and half will see equally dramatic changes.

Mexico and India are capitalist countries but with traditionally heavy central-government intervention and government ownership of key industries. Historically, their economies have been somewhat closed to foreign investment and international competition. This relative isolation is now changing, because both governments are privatizing their industry holdings and opening up to the global economy. Their financial accounting systems are more developed than China's in terms of standard setting, requirements, and practices. Naturally, accounting is evolving in these two countries as well, but not as rapidly as in China.

Exhibit 4-1 contains some comparative economic data about the five countries that are the focus of this chapter. China's area dwarfs the others'. Another contrast is gross domestic product (GDP) per capita and by sector. Overall, China and India are significantly poorer than the other three nations, and their economies are much more agricultural. Both of these factors are indicators of significant development potential.

EXHIBIT 4-1 Economic Data for Selected Countries

	United States	Mexico	Japan	China	India
Area: sq. km. (in thousands)	9,827	1,973	378	9,597	3,288
Population (in millions)	301	108	128	1,324	1,120
Gross Domestic Product (in billions)	$13,164	$839	$4,368	$2,645	$912
GDP Per Capita	$43,730	$7,750	$34,080	$2,000	$810
GDP by Sector					
Agriculture	1%	4%	1%	11%	17%
Industry	20%	34%	26%	49%	29%
Services	79%	62%	72%	40%	54%
Imports (in billions)	$1,953	$256	$579	$792	$191
Exports (in billions)	$1,163	$250	$646	$969	$126
Market Capitalization (in billions), end 2007	$19,947	$398	$4,453	$6.226	$1,819
Major Trading Partners	Canada, Mexico, China	U.S.A., China	U.S.A., China, S. Korea	U.S.A., Japan, Hong Kong	U.S.A., China

Source: Compiled from *Pocket World in Figures, 2009 Edition* (London: The Economist, 2008) and *The World Factbook*, www.cia.gov/library/publications/the-world-factbook/, May 2009.

[2] *Economist*, "Now for the Hard Part: A Survey of India" (June 3, 2006): 3.

The United States is at the other end of the economic spectrum. Its GDP (in absolute terms and per capita) and stock market capitalization exceed that of the other countries. Its economy is also more service oriented than that of the others. The United States is the largest trading partner of the other four countries.[3] Japan also has an advanced economy, as evidenced by its GDP (in absolute terms, per capita, and by sector) and stock market capitalization. Japan is also a major trading partner of China and Mexico, in addition to the United States.

Political and economic ties have been an important influence on accounting in these five countries. U.S. accounting was originally imported from Great Britain (along with the English language and the common law legal system). Most of the first accountants in the United States were British expatriates. However, as a result of the growth of U.S. economic and political power in the 20th century, U.S. ideas on accounting and financial reporting have had substantial influence on the rest of the world for some time now. Mexico's close economic ties with the United States are why it has fairness-oriented accounting despite being a code law country. India was once part of the British Empire. Like the United States, India imported its accounting from Great Britain. In China, the effect of political and economic ties is more anticipatory than historical. China is basing its new accounting standards on International Financial Reporting Standards (IFRS) because it hopes to better communicate with the foreign investors so vital to its economic development plans.

As discussed later, the accounting standard-setting bodies in the United States, Mexico, Japan, and China are committed to converging their national generally accepted accounting principles (GAAP) with IFRS. Thus, national financial reporting standards will remain in these countries, though closely aligned with IFRS. India, on the other hand, plans to adopt IFRS as its local reporting requirement, thus doing away with Indian GAAP.

FIVE NATIONAL FINANCIAL ACCOUNTING SYSTEMS[4]

United States

Accounting in the United States is regulated by a private-sector body (the Financial Accounting Standards Board, or FASB), but a governmental agency (the Securities and Exchange Commission, or SEC) underpins the authority of its standards. The key link allowing this shared-power system to work effectively is the 1973 SEC Accounting Series Release (ASR) No. 150. This release states:

> The Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles. For purposes of this policy, principles, standards, and practices promulgated by the FASB in its statements and interpretations, will be considered by the

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[3] The United States accounts for more than two-thirds of Mexico's exports and imports.

[4] The discussion in this section draws on the references cited in this chapter and on references cited in earlier editions of this book. The Big Four accounting firms and the IAS Plus Web site (www.iasplus.com) periodically update details of accounting in individual countries. For example, the discussion of accounting in India later in this chapter is based in part on Deloitte, *IFRSs and Indian GAAP: A Comparison* (March 2008), www.iasplus.com/asia/2008ifrsindiangaap.pdf.

> Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.[5]

Until 2002, the American Institute of Certified Public Accountants (AICPA), another private-sector body, set auditing standards. In that year, the Public Company Accounting Oversight Board (PCAOB) was established, with broad powers to regulate audits and auditors of public companies. The PCAOB, discussed later, is a private organization overseen by the SEC.[6]

ACCOUNTING REGULATION AND ENFORCEMENT The U.S. system has no general legal requirements for the publication of periodic audited financial statements. Corporations in the United States are formed under state law, not federal law. Each state has its own corporate statutes; in general, these contain minimal requirements for keeping accounting records and publishing periodic financial statements. Many of these statutes are not rigorously enforced, and reports rendered to local agencies are often unavailable to the public. Thus, annual audit and financial reporting requirements realistically exist only at the federal level as specified by the SEC. The SEC has jurisdiction over companies listed on U.S. stock exchanges and companies traded over-the-counter.[7] Other limited-liability companies have no such compulsory requirements for financial reporting, making the United States unusual by international norms.

The SEC has the legal authority to prescribe accounting and reporting standards for public companies but relies on the private sector to set the standards. It works with the FASB and exerts pressure when it believes the FASB is moving too slowly or in the wrong direction. At times, the SEC has delayed or overruled pronouncements or has imposed its own requirements.

Since the SEC is an independent regulatory agency, Congress and the president have no direct influence over its policies. However, the five full-time SEC commissioners are appointed by the president and confirmed by the Senate, and the SEC has only those powers that Congress has granted it by statute. As part of the regulatory process, the SEC issues Accounting Series Releases, Financial Reporting Releases, and Staff Accounting Bulletins. Regulations SX and SK contain the rules for preparing financial reports that must be filed with the SEC. Annual filings by U.S. and Canadian companies are on Form 10K, while those from non-Canadian foreign companies are on Form 20F.[8]

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[5] Securities and Exchange Commission, *Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards*, Accounting Series Release No. 150. Reprinted in *The Development of SEC Accounting*, G. J. Previts, ed., Reading, MA: Addison-Wesley, 1981, 228. The SEC reaffirmed the FASB as the designated accounting standard setting body in April 2003. This reaffirmation followed an SEC study of the U.S. accounting standards setting process, as mandated by the 2002 Sarbanes-Oxley Act (discussed later).

[6] The Web sites of these organizations are: Securities and Exchange Commission: www.sec.gov; Financial Accounting Standards Board: www.fasb.org; American Institute of Certified Public Accountants: www.aicpa.org; and Public Company Accounting Oversight Board: www.pcaobus.org.

[7] There are approximately 15,000 companies that must report to the SEC, including over 1,100 foreign companies. Companies traded on the "pink sheets" over-the-counter market are exempt from the SEC's periodic filing requirements if they meet a minimum-size test and certain other requirements.

[8] The SEC rigorously enforces its filing requirements. Over half of SEC filers had their disclosures reviewed by the SEC in 2005, twice the percentage from a few years earlier.

The FASB was established in 1973[9] and as of June 2009 issued 165 Statements of Financial Accounting Standards (SFASs). The objective of the SFASs is to provide information that is useful to present and potential investors, creditors, and others who make investment, credit, and similar decisions. The FASB has five full-time members, representing accounting firms, academia, corporations, and the investor community. Board members must sever all economic and organizational ties to prior employers or ownership in order to serve. The FASB's use of a conceptual framework is a significant feature of accounting standard setting in the United States. Statements of Financial Accounting Concepts set forth the fundamentals on which financial accounting and reporting standards are based.

The FASB goes through lengthy due-process procedures before issuing an SFAS. In developing its work agenda, it listens to individuals, professional firms, courts of law, companies, and government agencies. It also relies on an emerging-issues task force and an advisory council to help identify accounting issues that need attention. Once a topic is added to the agenda, the FASB's technical staff does research and analysis and an advisory task force is appointed. A Discussion Memorandum or other discussion document is disseminated for comment, and public hearings are held. The FASB considers oral and written comments in meetings open to the public. Next, an Exposure Draft is issued and further public comments are considered. The process ensures that standard setting in the United States is both political and technical. An SFAS must be approved by three of the five members.

Generally accepted accounting principles (GAAP) comprise all the financial accounting standards, rules, and regulations that must be observed in the preparation of financial reports. The SFASs are the major component of GAAP. The accounting and auditing regulations are probably more voluminous in the United States than in the rest of the world combined and substantially more detailed than in any other country. For this reason, the FASB and SEC are considering moving U.S. GAAP away from rules-based standards toward principles-based standards.

The FASB did not seriously engage itself internationally until the 1990s. In 1991, the FASB developed its first strategic plan for international activities. In 1994, the FASB added the promotion of international comparability to its mission statement. The FASB is now a major cooperative international player, committed to converging U.S. GAAP and IFRS. In 2002, the FASB and IASB formalized their commitment to convergence by signing the so-called Norwalk Agreement. Under this agreement, the two boards pledge to remove existing differences between their standards and coordinate future standard setting agendas so that major issues are worked on together.[10] The commitment to convergence was reaffirmed in 2005. Convergence is scheduled for completion in 2011.

The Sarbanes-Oxley Act was signed into law in 2002, significantly expanding U.S. requirements on corporate governance, disclosure and reporting, and the regulation of the audit profession. Among its more important provisions is the

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[9] Two other private-sector bodies established U.S. generally accepted accounting principles (GAAP) before the FASB. These were the Committee on Accounting Procedure (1938 to 1959) and the Accounting Principles Board (1959 to 1973).

[10] For example, the FASB and IASB have issued a joint discussion paper on improving their conceptual frameworks. The intention is to develop a common conceptual framework.

creation of the PCAOB, a nonprofit organization overseen by the SEC. The PCAOB is responsible for:

- Setting auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports on companies issuing securities to the public
- Overseeing the audit of public companies subject to the securities laws
- Inspecting registered public accounting firms
- Conducting investigations and disciplinary proceedings
- Sanctioning registered public accounting firms, and referring cases to the SEC or other enforcement bodies for further investigation

Previously, the AICPA issued auditing standards, was responsible for the Code of Professional Ethics, and disciplined auditors. The PCAOB effectively assumed these responsibilities from the AICPA.[11]

The Sarbanes-Oxley Act was passed in the wake of numerous corporate and accounting scandals, such as Enron and WorldCom. The act limits the services that audit firms can offer clients and prohibits auditors from offering certain nonaudit services (including types of consulting services) to audit clients. It also requires that lead audit partners rotate off audits every five years. Section 302 of the act requires a company's chief executive officer and chief financial officer to certify each quarterly and annual report. Section 404 requires management's assessment of internal control over financial reporting, along with a related report by the independent auditor.[12]

Thus, the auditor's report covers both the financial statements and internal controls. For example, the auditor's report on the financial statements in Colgate-Palmolive's 2008 annual report says the following:

> In our opinion, the consolidated financial statements . . . present fairly, in all material respects, the financial position of Colgate-Palmolive Company and its subsidiaries . . . at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

The auditor's report on internal controls over financial reporting says the following:

> [I]n our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

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[11] The act is the most substantial piece of U.S. business legislation since the 1934 Securities Exchange Act established the SEC.

[12] Section 404 is viewed by many observers as the most burdensome (and costly) provision of the act. The PCAOB has five board members, two CPAs and three non-CPAs. Board members are appointed by the SEC after consultation with the Chairman of the Federal Reserve Board and the Secretary of the Treasury. They serve five-year terms. The PCAOB is funded by fees assessed against SEC-registered public companies and registered accounting firms.

Financial statements are supposed to "present fairly" the financial position of the company and the results of its operations "in conformity with generally accepted accounting principles." Compliance with GAAP is the test for fair presentation. There is no subjective override, such as the "true and fair" override in the United Kingdom. The SEC also expects compliance with GAAP and will not accept an auditor's report with an "adverse" opinion.

FINANCIAL REPORTING[13] A typical annual financial report of a large U.S. corporation includes the following components:

1. Report of management
2. Report of independent auditors
3. Primary financial statements (income statement, balance sheet, statement of cash flows, statement of comprehensive income, and statement of changes in stockholders' equity, etc.)
4. Management discussion and analysis of results of operations and financial condition
5. Disclosure of accounting policies with the most critical impact on financial statements
6. Notes to financial statements
7. Five- or ten-year comparison of selected financial data
8. Selected quarterly data

Consolidated financial statements are required, and published U.S. financial reports typically do not contain parent-company-only statements. Consolidation rules require that all controlled subsidiaries (i.e., ownership of more than 50 percent of the voting shares) be fully consolidated, including those with nonhomogeneous operations.[14] Interim (quarterly) financial reports are required for companies listed on major stock exchanges. These reports typically contain only abbreviated, unaudited financial statements and a concise management commentary.

ACCOUNTING MEASUREMENTS Accounting measurement rules in the United States assume that a business entity will continue as a going concern. Accrual basis measurements are pervasive, and transactions and events-recognition rules rely heavily on the matching concept. A consistency requirement insists on uniformity of accounting treatment of like items within each accounting period and from one period to the next. If changes in practices or procedures occur, the changes and their effects must be disclosed.

Business combinations must be accounted for as a purchase. Goodwill is capitalized as the difference between the fair value of the consideration given in the exchange and the fair value of the underlying net assets acquired (including other intangibles). It is reviewed for impairment annually and written off and expensed to earnings when its

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[13] In 2008, the SEC issued a proposal that would permit the use of IFRS by certain U.S. issuers. The SEC also proposed a "roadmap" with a timetable and milestones that need to be achieved for the mandatory transition to IFRS for all U.S. issuers, starting in 2014.

[14] The FASB has proposed extending the consolidation requirement to other entities that a company controls based on its ability to direct the entity's policies and management.

book value exceeds its fair value.[15] Proportional consolidation is not practiced. Joint ventures are accounted for using the equity method, as are investments nonconsolidated, 20 percent– to 50 percent–owned affiliated companies. Foreign currency translation follows the requirements of SFAS No. 52, which relies on the foreign subsidiary's functional currency to determine translation methodology (Chapter 6).

The United States relies on historical cost to value tangible and intangible assets. Revaluations are permitted only after a business combination. Both accelerated and straight-line depreciation methods are permissible. Estimated economic usefulness determines depreciation and amortization periods. All research and development costs are typically expensed as incurred, though there are special capitalization rules for computer software costs.

LIFO, FIFO, and average cost methods are permissible and widely used for inventory pricing. LIFO is popular because it can be used for federal income tax purposes. However, if LIFO is used for tax purposes, it must also be used for financial reporting purposes. Marketable securities are valued at market unless they are classified as held-to-maturity and valued at historical cost.[16]

When financial leases are in substance the purchase of property, the value of the property is capitalized and a corresponding liability is booked.[17] The costs of pensions and other post-retirement benefits are accrued over the periods in which employees earn their benefits, and unfunded obligations are reported as a liability. Contingent losses/ liabilities are accrued when they are probable and the amount can be reasonably estimated.[18] Income-smoothing techniques are not allowed.

Finally, there is the issue of deferred taxes, because (except for LIFO) financial and tax reporting are distinct. Income taxes are accounted for using the liability method. Deferred taxes are accrued for the tax effects of temporary differences between financial and tax accounting methods, and are measured based on the future tax rates that will apply when these items reverse. Comprehensive income tax allocation is required.

Chapter 3 described IFRS. Some of the significant differences between U.S. GAAP and IFRS are summarized in Exhibit 4-2.

Mexico

Before the Spanish conquest in the 1500s, Mexico was home to several highly advanced cultures, including the Olmecs, Mayas, Toltecs, and Aztecs. Hernando

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[15] Both the purchase and pooling-of-interests (merger) methods were previously used to account for business combinations. They were not alternatives: pooling-of-interests was used when the combination met specified criteria. Under the purchase method, goodwill was capitalized and amortized on a straight-line basis over a maximum of 40 years and the amortization amount was included in current period income. SFAS 141 and 142, issued in 2001, changed how business combinations were accounted for, as described above.

[16] Unrealized gains and losses from value changes on trading securities are recognized in current income while unrealized gains and losses on available-for-sale securities are taken to equity.

[17] The FASB is proposing that all material leases be capitalized, discontinuing the distinction between financing and operating leases.

[18] The FASB is deliberating the definitions of the elements of the financial statements in its joint Conceptual Framework project with the International Accounting Standards Board. The term "contingent liability" will probably no longer be used. Instead, liabilities will be assessed in terms of whether they are "conditional or unconditional obligations." See *Conceptual Framework – Phase B: Elements and Recognition* at the FASB Web site is www.fasb.org.

EXHIBIT 4-2 Significant Differences between U.S. GAAP and IFRS

Accounting Issue	U.S. GAAP	IFRS
1. Nature of standards	Rules-based with significantly more implementation guidance	Principles-based
2. Revaluations of property, plant, and equipment	Prohibited: historical costs only	Allowed
3. Extraordinary items on income statement	Used	Prohibited
4. Consolidation of subsidiaries	Based on voting interest	Based on control
5. Joint ventures	Equity method	Proportional consolidation or equity method
6. Development costs	Expensed	Capitalized
7. LIFO	Permitted	Prohibited

1. U.S. GAAP is more rules-based with significantly more implementation guidance, while IFRS are more principles-based.
2. Revaluations of property, plant, and equipment are not allowed under U.S. GAAP. Only historical cost may be used. Revaluations are allowed under IFRS.
3. Extraordinary gains and losses are disclosed on the income statement under U.S. GAAP, but are prohibited under IFRS.
4. Under U.S. GAAP, consolidation is based on ownership: owning more than 50% of a subsidiary' voting power. Consolidation is based on control under IFRS. Control means the power to govern the subsidiary's financial and operating policies.
5. Only the equity method is used to account for joint ventures under U.S. GAAP. Joint ventures are accounted for by either proportional consolidation or the equity method under IFRS.
6. Development costs are expensed under U.S. GAAP. Development costs are capitalized when certain conditions are met under IFRS.
7. LIFO is permitted under U.S. GAAP, but it is not permitted under IFRS.

Note: Detailed differences between U.S. GAAP and IFRS are available from various online sources. A search of "U.S. GAAP versus IFRS" will reveal the most up-to-date ones.

Cortés conquered Mexico in 1521 and founded a Spanish colony that lasted for nearly 300 years. Mexico declared independence in 1810, and an 1821 treaty recognized its independence from Spain. Except for 30 years of internal peace under General Porfírio Díaz (1877 to 1880 and 1884 to 1911), Mexico experienced political and military strife until 1929, when what is now known as the Institutional Revolutionary Party (PRI) was formed. The PRI controlled Mexico's government continuously for 70 years. The 2000 presidential election was won by the National Action Party (PAN), a center-right opposition party, thus ending the supremacy of the PRI in Mexican politics.[19]

[19] For a history of the 2000 election, see J. Preston and S. Dillon, *The Making of Democracy* (New York: Farrar, Straus, & Giroux, 2004). The PAN also won the divisive, and contested, 2006 election.

Mexico is the most populous Spanish-speaking country in the world and the second most populous country in Latin America (after Portuguese-speaking Brazil).[20] Mexico has a largely free-market economy: Government-owned or controlled companies dominate petroleum and public utilities, but private enterprise dominates manufacturing, construction, mining, entertainment, and the service industries. In recent years, the government has been privatizing its holdings in nonstrategic industries. Free-market economic reforms during the 1990s helped reduce inflation, increase the rate of economic growth, and deliver healthier economic fundamentals. The reforms included dismantling protectionist trade barriers, opening up to foreign investment, and signing regional trade agreements. The most important agreement for Mexico is the North American Free Trade Agreement (NAFTA), signed with Canada and the United States in 1994. The United States accounts for nearly half of Mexico's imports and 85 percent of Mexico's exports. Mexico has the world's fourteenth-largest economy (in terms of gross domestic product).[21]

Family-controlled conglomerates dominate Mexico's private sector and, by world standards, are relatively small.[22] Although Mexico's stock market is the second largest in Latin America, it is still relatively small by international standards, because firms prefer to raise capital through debt rather than equity. Given the dominance of family-controlled enterprises, Mexican companies traditionally guarded their information and were secretive in their financial reporting. This is changing, however, and more and more Mexican firms are entering U.S. capital markets. Disclosure practices of Mexican companies are increasingly influenced by the expectations of the U.S. market.

The U.S. influence on Mexico's economy extends to accounting. "[M]any of the early leaders of the Mexican profession grew up on 'American accounting,'"[23] and U.S. textbooks and professional literature (either in the original English or translated into Spanish) are used extensively in the education of accountants and as guidance on accounting issues. NAFTA accelerated a trend toward closer cooperation between professional accounting organizations in Mexico, Canada, and the United States. As a founding member of the International Accounting Standards Committee (now the International Accounting Standards Board), Mexico is also committed to convergence with IFRS. Mexico now looks to the IASB for guidance on accounting issues, especially in cases where there is no corresponding Mexican standard.

ACCOUNTING REGULATION AND ENFORCEMENT The Mexican Commercial Code and income tax laws contain requirements for keeping certain summary accounting records and preparing financial statements, but their influence on financial reporting is generally minimal. Accounting standards are issued by the Council for Research and Development of Financial Information Standards (Consejo Mexicano para

[20] The capital, Mexico City, is the second most populous city in the world.
[21] *Pocket World in Figures, 2009 Edition* (London: *The Economist*, 2008): 26 and 181.
[22] It is estimated that up to 95 percent of Mexican businesses are family owned. Over 40 percent of the value of the Mexican stock market is in firms controlled by one family. See "Still Keeping It in the Family," *Business Week* (March 20, 2004): 63–64.
[23] Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (Champaign, IL: Stipes Publishing, 1971): 96–97.

la Investigación y Desarrollo de Normas de Información Financiera, or CINIF). CINIF is an independent public/private-sector partnership patterned after the U.S. Financial Accounting Standards Board and the International Accounting Standards Board. Its specific aim is to converge Mexican GAAP with IFRS.[24] The Mexican Institute of Public Accountants (Instituto Mexicano de Contadores Públicos) issues auditing standards through its Auditing Standards and Procedures Commission. The institute, a federation of state and other local associations of registered public accountants, is an independent nongovernmental professional association representing the overwhelming majority of public accountants. The Mexican accounting profession is mature, well organized, and highly regarded by the business community.

Despite a legal system based on civil law, accounting standard setting in Mexico takes a British-American, or Anglo-Saxon, approach rather than a continental European one. The standard-setting process is well developed. Before standards are finalized, exposure drafts of proposed standards are issued for review and public comment. Accounting standards are recognized as authoritative by the government, and in particular by the National Banking and Securities Commission, which regulates the Mexican Stock Exchange. Mexican accounting principles do not distinguish between large and small companies, and so are applicable to all business entities. In some cases the National Banking and Securities Commission issues rules for listed companies that limit certain options in generally accepted accounting principles.

Requirements for preparing financial statements and having them audited vary by type and size of company. All companies incorporated under Mexican law (*sociedades anónimas*) must appoint at least one statutory auditor to report to the shareholders on the annual financial statements. Statutory auditors do not have to be public accountants, but when a firm uses independent auditors, a member of the auditing firm frequently acts as statutory auditor. Companies or consolidated groups that meet certain size criteria must file a tax-compliance audit report every year with the Federal Tax Audit Department of the Ministry of Finance. The report consists of audited financial statements, additional schedules, and a statement by the auditor that no irregularities were observed regarding compliance with tax laws. This audit must be done by a Mexican public accountant. Finally, companies listed on the Mexican Stock Exchange must submit annual consolidated financial statements audited by a Mexican public accountant both to the exchange and to the National Banking and Securities Commission.

Starting in 2012, all companies listed on the Mexican Stock Exchange will be required to use IFRS in their financial statements. Listed companies also have the option of using IFRS earlier (from 2008 on). Mexican GAAP, as developed by CINIF, will continue to be required for nonlisted companies.

[24] The Web site is www.cinif.org.mx. CINIF was established in 2004 and took over from the Mexican Institute of Public Accountants' Accounting Principles Commission, which had been responsible for developing accounting standards since 1968. CINIF was created by a mutual agreement of organizations representing financial executives, securities brokers, financial institutions, the stock exchange, and the accounting profession, among others. It is backed by government agencies such as the National Banking and Securities Commission, discussed later.

FINANCIAL REPORTING The fiscal year of Mexican companies must coincide with the calendar year. Comparative consolidated financial statements must be prepared, consisting of:

1. Balance sheet
2. Income statement
3. Statement of cash flows
4. Statement of changes in stockholders' equity
5. Notes

Until 2008, financial statements were adjusted for inflation, that is, general price level accounting was used. The historical costs of nonmonetary assets were restated into pesos of current purchasing power. The components of stockholders' equity were also restated. The gain or loss from holding monetary assets and liabilities were included in current period income, but the effects of other restatements were in stockholders' equity. A statement of changes in financial position, similar to the statement of cash flows, was also presented. However, because it was prepared in constant pesos, the resulting amounts were not cash flows as understood under historical cost accounting. Exhibit 4-3 illustrates the difference for CEMEX, the Mexican cement company. The 2007 20F report filed with the SEC reports amounts in the statement of changes in financial position (adjusted for inflation) as well as cash flow amounts (under historical cost).[25] Under Mexican Financial Reporting Standard B-10 ("Inflation Effects"), effective 2008, inflation accounting is only used when the three-year cumulative inflation rate equals or exceeds 26 percent.

Notes are an integral part of the financial statements (covered by the auditor's report) and include the following:

- Accounting policies of the company
- Material contingencies
- Commitments for substantial purchases of assets or under lease contracts

EXHIBIT 4-3 CEMEX Statement of Changes in Financial Position and Cash Flow Disclosures

	2007	2006	2005
Statement of Changes in Financial Position (adjusted for inflation)			
• Net resources provided by operating activities	Ps 45,625	47,845	43,080
• Resources provided by (used in) financing activities	130,349	(12,140)	8,450
• Resources used in investing activities	(185,798)	(24,762)	(48,302)
Cash Flows (historical cost)			
• Net cash provided by operating activities	Ps 33,431	17,484	28,909
• Net cash provided by (used in) financing activities	135,891	(5,762)	12,502
• Net cash used in investing activities	(177,707)	(1,152)	(38,818)

Source: 2007 CEMEX 20F, pp. F-7 and F-68.

[25] CEMEX is listed on the New York Stock Exchange and must therefore file Form 20F with the SEC.

- Details of long-term debt and foreign currency exposure
- Limitations on dividends
- Guarantees
- Employees' pension plans
- Transactions with related parties
- Income taxes

ACCOUNTING MEASUREMENTS[26] Consolidated financial statements are prepared when a parent company controls another company. Control is indicated by the ability to determine a company's operating and financial policies. Control normally exists when more than 50 percent of a company's common stock is owned, but it can also be obtained in other ways, including the ability to appoint management or a majority of the board of directors. The equity method is used when there is influence but not control, normally meaning an ownership level between 10 and 50 percent. Joint ventures may be proportionally consolidated or accounted for using the equity method. Mexico has adopted International Accounting Standard No. 21 on foreign currency translation.[27]

The purchase method is used to account for business combinations. Goodwill is the excess of purchase price over the current value of the net assets acquired. It is not amortized, but subject to an annual impairments test. An intangible asset is amortized over its useful life (normally no more than 20 years) unless the life is indefinite, in which case it is not amortized but subject to an annual impairments test.

Research costs are expensed as incurred, while development costs are capitalized and amortized once technological feasibility has been established. Leases are classified as financing or operating. Financing leases—those transferring substantially all the benefits and risks of ownership of the asset—are capitalized, while rents from operating leases are expensed on the income statement. Contingent losses are accrued when they are likely and measurable. General contingency reserves are not acceptable under Mexican GAAP. Deferred taxes are provided for in full, using the liability method. The costs of employee pensions, seniority premiums,[28] and termination pay are accrued currently when they can be reasonably estimated based on actuarial calculations. Statutory (legal) reserves are created by allocating 5 percent of income each year until the reserve equals 20 percent of the value of the outstanding capital stock.

Japan

Japanese accounting and financial reporting reflect a mixture of domestic and international influences. Two separate government agencies have responsibility for accounting

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[26] Because of the long-time influence of the United States and the more recent influence of the IASB, Mexican financial reporting practices have always been fairness oriented.

[27] When general price level accounting (described above) is used, it is integrated with foreign currency translation: (1) the financial statements of integrated operations are adjusted by the National Consumer Price Index after translation into pesos; (2) financial statements of "foreign entities" (i.e., subsidiaries that are not integrated operations) are first adjusted to reflect the purchasing power of the home currency, then translated into pesos using the closing exchange rate.

[28] Seniority premiums are compensation amounts paid at the termination of employment based on how long the employee has worked. Generally, employees who voluntarily retire must have worked for at least 15 years, but there is no minimum number of years for other types of termination, such as redundancy layoffs, or if an employee dies.

regulations, and there is the further influence of Japanese corporate income tax law. In the first half of the 20th century, accounting thinking reflected German influences; in the second half, U.S. ideas were pervasive. More recently, the effects of the International Accounting Standards Board have been felt, and in 2001 a profound change occurred with the establishment of a private-sector accounting standard setting organization.[29]

To understand Japanese accounting, one must understand Japanese culture, business practices, and history. Japan is a traditional society with strong cultural and religious roots. The group consciousness and interdependence in personal and corporate relationships in Japan contrast with the independent, arm's-length relationships among individuals and groups in Western nations. Japanese companies hold equity interests in each other, and often jointly own other firms. These interlocking investments yield giant industrial conglomerates—notably the *keiretsu*. Banks are often a part of these industrial groups. The widespread use of bank credit and debt capital to finance large enterprises is unusually great from a Western perspective, and corporate managers must primarily answer to banks and other financial institutions rather than shareholders. Central government also exerts tight control on many activities in Japan, which means a strong bureaucratic control over business affairs, including accounting. Knowledge of corporate activities is primarily limited to the corporation and other insiders, such as the banks and the government.

This *keiretsu* business model is being transformed as the Japanese undertake structural reforms to counteract the economic stagnation that occurred in the 1990s.[30] The financial crisis that followed the bursting of Japan's "bubble economy" also prompted a review of Japanese financial reporting standards. It became clear that many accounting practices hid how badly Japanese companies were doing. For example:

1. Loose consolidation standards allowed Japanese companies to bury loss-making operations in affiliates. Investors could not see whether a company's entire operations were really profitable.
2. Pension and severance obligations were only accrued to 40 percent of the amount owed because that was the limit of their tax deductibility. This practice led to substantial underfunding of pension obligations.
3. Securities holdings were valued at cost, not market prices. Designed to reinforce the cohesion of the *keiretsu*, these cross-holdings are vast. Companies held on to the ones with losses, but sold those with gains to prop up sagging profits.

An accounting "Big Bang" was announced in the late 1990s to make the economic health of Japanese companies more transparent and to bring Japan more in line with international standards. These accounting reforms are described later.[31]

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[29] Until the late 1990s, external influences came to bear only gradually. In terms of what we would consider world-class reporting, accounting was slow to develop in Japan. For example, consolidated financial statements date from 1976 and requirements for segment reporting began in 1990.

[30] For example, in 1992, 46 percent of listed equities were held as cross-shareholdings by related companies. By 2004, cross-shareholdings accounted for 24 percent of shares.

[31] "Japan on the Brink," *Economist* (April 11, 1999): 15–17; "Japan Restructures, Grudgingly," *Economist* (February 6, 1999): 63–65; "The Secrets Pour Out," *Business Week* (August 2, 1999): 50–51; "Reshaping Standards," *Accountancy* (June 2000): 110; "Japan: Restoring Investor Confidence," *IASC Insight* (September 2000): 8; "Going International," *Accountancy* (March 2002): 102–103; "The Sun Also Rises: A Survey of Japan," *Economist* (October 8, 2005): 1–18.

ACCOUNTING REGULATION AND ENFORCEMENT The national government has a significant influence on accounting in Japan. Accounting regulation is based on three laws: the Company Law, the Securities and Exchange Law, and the Corporate Income Tax Law. These three laws are linked and interact with each other. A leading Japanese scholar refers to the situation as a "triangular legal system."[32]

The Company Law is administered by the Ministry of Justice (MOJ). Developed from German commercial law, the original code was enacted in 1890 but not implemented until 1899. Creditor and shareholder protection is its fundamental principle, with an unequivocal reliance on historical cost measurements. Disclosures on creditworthiness and the availability of earnings for dividend distribution are of primary importance. All companies incorporated under the Company Law are required to meet its accounting provisions.

Publicly owned companies must meet the further requirements of the Securities and Exchange Law (SEL), administered by the Financial Services Agency (FSA).[33] The SEL is modeled after the U.S. Securities Acts and was imposed on Japan by the United States during the U.S. occupation following World War II. The main objective of the SEL is to provide information for investment decision-making. Although the SEL requires the same basic financial statements as the Company Law, the terminology, form, and content of financial statements are more precisely defined under the SEL; certain financial statement items are reclassified for presentation, and additional detail is provided. Net income and shareholders' equity are, however, the same under the Company Law and the SEL.

Until recently, a special advisory body to the FSA was responsible for developing accounting standards under the SEL. Called the Business Accounting Deliberation Council (BADC), and now the Business Accounting Council (BAC), it was arguably the major source of generally accepted accounting principles in Japan.[34] However, a major change in accounting standard setting occurred in 2001 with the establishment of the Accounting Standards Board of Japan (ASBJ) and its related oversight foundation, the Financial Accounting Standards Foundation (FASF). The ASBJ now has sole responsibility for developing accounting standards and implementation guidance in Japan. It has 15 members, four of whom are full-time. It also has a full-time technical staff to support its activities. The FASF is responsible for funding and naming its members. Funding comes from companies and the accounting profession, not the government. As an independent private-sector organization, the ASBJ is stronger and more transparent than the BAC, and subject to fewer political and special-interest pressures.[35] The ASBJ collaborates with the IASB in developing IFRS and in 2005 launched a joint project with the IASB to reduce differences between Japanese accounting standards and IFRS. The so-called Tokyo Agreement between the ASBJ and IASB, announced in 2008, targets 2011 as the date for full convergence between

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32 Kiyomitsu Arai, *Accounting in Japan* (Tokyo: Waseda University, Institute for Research in Business Administration, 1994): 5.

33 The FSA is the government regulatory agency responsible for supervising private-sector financial institutions, such as banks, insurance companies, and the securities exchanges. It took over the administration of the SEL from the Ministry of Finance when it was established in 2000. As discussed later, it also oversees the Certified Public Accountant and Auditing Oversight Board. The FSA Web site is www.fsa.go.jp/en.

34 Before 2000, the BADC reported to the Ministry of Finance (see preceding footnote).

35 The standard setting framework is similar to that of the U.S. Financial Accounting Foundation and Financial Accounting Standards Board, as discussed in this chapter. The FASF and ASBJ Web site is www.asb.or.jp.

the two sets of standards. The BAC still advises the FSA on accounting matters. As discussed later, the BAC is responsible for establishing auditing standards. Japanese accounting standards cannot be at variance with commercial law (or tax law, as discussed next). Thus, the triangulation of accounting standards, company law, and tax law is still a feature of Japanese financial reporting.

Finally, the influence of the tax code is important. As in France, Germany, and elsewhere, expenses can be claimed for tax purposes only if they are fully booked. Taxable income is based on the amount calculated under the Company Law.

Under the Company Law, the financial statements and supporting schedules of small and medium-sized companies are subject to audit only by statutory auditors. Both statutory and independent auditors must audit large corporations. Independent auditors must audit financial statements of publicly held companies in accordance with the Securities and Exchange Law. Statutory auditors do not need any particular professional qualification and are employed by the company on a full-time basis. Statutory audits focus mainly on the managerial actions of the directors and whether they perform their duties in compliance with legal statutes. Independent audits involve examining the financial statements and records, and must be performed by certified public accountants (CPAs).

The Japanese Institute of Certified Public Accountants (JICPA) is the professional organization of CPAs in Japan. All CPAs must belong to the JICPA.[36] In addition to providing guidance on the conduct of audits, the JICPA publishes implementation guidelines on accounting matters, and provides input to the ASBJ in developing accounting standards. Generally accepted auditing standards are promulgated by the BAC rather than the JICPA. The Certified Public Accountant and Auditing Oversight Board was established in 2003. A government agency, it is designed to monitor and oversee the auditing profession and improve the quality of Japanese audits. It was put under the FSA in 2004.

FINANCIAL REPORTING Companies incorporated under the Company Law are required to prepare a statutory report for approval at the annual shareholders' meeting, consisting of the following:

1. Balance sheet
2. Income statement
3. Statement of changes in shareholders' equity
4. Business report
5. Supporting schedules

Notes accompanying the balance sheet and income statement describe the accounting policies and provide supporting details, as is typical in other countries. The business report contains an outline of the business and its internal control systems, and information about its operations, financial position, and operating results. A number of supporting schedules are also required, separate from the notes, including:

- Changes in bonds and other short- and long-term debt
- Changes in fixed assets and accumulated depreciation
- Collateralized assets

[36] The Web site is www.hp.jicpa.or.jp.

- Debt guarantees
- Changes in provisions
- Amounts due to and from the controlling shareholders
- Equity ownership in subsidiaries and the number of shares of the company's stock held by subsidiaries
- Receivables due from subsidiaries
- Transactions with directors, statutory auditors, controlling shareholders and third parties that create a conflict of interest
- Remuneration paid to directors and statutory auditors

This information is prepared for a single year on a parent-company basis and is audited by the statutory auditor. The Company Law does not require a statement of cash or funds flow.

Listed companies also must prepare financial statements under the Securities and Exchange Law, which generally requires the same basic statements as the Company Law plus a statement of cash flows. However, under the SEL, consolidated financial statements, not the parent-company statements, are the main focus. Additional footnotes and schedules are also required.[37] Financial statements and schedules submitted under the SEL must be audited by independent auditors. Beginning in 2008, listed companies must issue quarterly financial reports. Also beginning in 2008, managements of listed companies must submit an annual assessment of the company's internal controls and a letter certifying the accuracy of the annual report. The internal control report must be audited.[38]

A cash flow forecast for the next six months is included as supplemental information in filings with the FSA. Other forecast information is also reported, such as forecasts of new capital investments and production levels and activities. Overall, the amount of corporate forecast reporting is extensive in Japan. However, this information is reported in statutory filings and rarely appears in the annual report to shareholders.

ACCOUNTING MEASUREMENTS The Company Law requires large companies to prepare consolidated financial statements. In addition, listed companies must prepare consolidated financial statements under the Securities and Exchange Law. Individual company accounts are the basis for the consolidated statements, and normally the same accounting principles are used at both levels. Subsidiaries are consolidated if a parent directly or indirectly controls their financial and operational policies. Business combinations are accounted for as a purchase. Goodwill is measured on the basis of the fair value of the net assets acquired and is amortized over 20 years or less and is subject to an impairment test. The equity method is used for investments in affiliated companies when the parent and subsidiaries exert significant influence over their financial and operational policies. The equity method is also used to account for joint ventures; proportional consolidation is not allowed. Under the foreign currency translation standard, assets and liabilities of foreign

[37] Additional footnotes include information about such things as subsequent events and liabilities for employee retirement and severance benefits. Additional schedules detail items on the financial statements, such as marketable securities, tangible and intangible assets, investments in and loans to or from affiliated companies, bonds payable and other long-term borrowings, and reserves and allowances.

[38] The law requiring an internal control assessment and certification of the financial statements is based on the U.S. Sarbanes-Oxley Act and is informally called the "J-Sox rule." However, unlike Sarbanes-Oxley it does not require the auditor's direct assessment of the company's internal control. Rather, the auditor's opinion covers management's assessment of internal controls.

subsidiaries are translated at the current (year-end) exchange rate, revenues and expenses at the average rate, and translation adjustments are in stockholders' equity.

Inventory must be valued at cost or the lower of cost or net realizable value. FIFO, LIFO, and average are all acceptable cost-flow methods, with average the most popular.[39] Investments in securities are valued at market. Fixed assets are valued at cost. The declining-balance method is the most common depreciation method. Fixed assets are also impairments tested.

Research and development costs are expensed when incurred. Finance leases are capitalized and amortized, while the costs of operating leases are expensed. Deferred taxes are provided for all timing differences using the liability method. Contingent losses are provided for when they are probable and can be reasonably estimated. Pension and other employee retirement benefits are fully accrued as employees earn them, and unfunded obligations are shown as a liability. Legal reserves are required: Each year a company must allocate an amount equal to at least 10 percent of cash dividends and bonuses paid to directors and statutory auditors until the legal reserve reaches 25 percent of capital stock.

Many of the accounting practices described above were implemented as a result of the accounting Big Bang referred to earlier. These changes include: (1) requiring listed companies to report a statement of cash flows; (2) extending the number of subsidiaries that are consolidated based on control rather than ownership percentage; (3) extending the number of affiliates accounted for using the equity method based on significant influence rather than ownership percentage; (4) valuing investments in securities at market rather than cost; (5) valuing inventory at the lower of cost or net realizable value rather than cost; (6) full provisioning of deferred taxes; and (7) full accrual of pension and other retirement obligations. In December 2009, the Financial Services Agency announced that listed Japanese companies may voluntarily adopt IFRS for fiscal periods starting on or after March 31, 2010. This is seen as a step toward full adoption of IFRS, expected around 2015.

China

China has one-fifth of the world's population, and market-oriented reforms have helped generate rapid economic growth.[40] In the late 1970s, Chinese leaders began to move the economy from Soviet-style central planning to a system that is more market-oriented but still under Communist Party control.[41] To achieve this, they switched to a system of

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[39] LIFO will no longer be permitted after 2010.

[40] In 1997, Great Britain ceded control of Hong Kong to China. Under the agreement between China and Britain, China has guaranteed to operate a "one country, two systems" arrangement in which Hong Kong's lifestyle will be unchanged for 50 years and basic freedoms and rights will be guaranteed by law. Accounting in Hong Kong is similar to accounting in the United Kingdom, described in Chapter 3. The discussion of China in this chapter refers to mainland China and excludes Hong Kong.

[41] China's real gross domestic product grew at an average annual rate of 10.3 percent between 1996 and 2006, one of the highest growth rates of any nation. See *The Economist Pocket World in Figures, 2009 Edition* (London: *The Economist*, 2008), p. 32. For much of recorded history, China was the largest economy in the world. Until the 15th century, China had the highest income per head and was the world's technological leader. For example, China led the world in its understanding of hydraulics, ironsmelting, and shipbuilding. Among China's inventions are the toothbrush, umbrella, playing cards, and paper. Even as late as 1820, it still accounted for 30 percent of the world's GDP. However, by 1950, its share of world output had fallen to less than 5 percent. See "The Dragon and the Eagle," *Economist* (October 2, 2004): 1–26.

household responsibility in agriculture instead of the old collectivization, increased the authority of local officials and plant managers in industry, permitted a wide variety of small-scale enterprises in services and light manufacturing, and opened the economy to increased foreign trade and investment. In 1993 China's leadership approved additional long-term reforms aimed at giving more flexibility for market-oriented institutions. Central features include the share system of ownership, privatizations, the development of organized stock exchanges, and the listing of shares in Chinese companies on Western exchanges. Nevertheless, state-owned enterprises still dominate many key industries in what the Chinese call a "socialist market economy," that is, a planned economy with market adaptations.[42]

Accounting in China has a long history. Its functioning in a stewardship role can be detected as far back as 2200 B.C. during the Hsiu Dynasty, and documents show that it was used to measure wealth and compare achievements among dukes and princes in the Xia Dynasty (2000 to 1500 B.C.). The young Confucius (551 to 479 B.C.) was a manager of warehouses, and his writings mention that the job included proper accounting—keeping the records of receipts and disbursements up-to-date. Among the teachings of Confucius is the imperative to compile a history, and accounting records are viewed as part of history.

The principal characteristics of accounting in China today date from the founding of the People's Republic of China in 1949. China installed a highly centralized planned economy, reflecting Marxist principles and patterned after the system in the Soviet Union. The state controlled the ownership, the right to use, and the distribution of all means of production, and enacted rigid planning and control over the economy. Production was the top priority of state-owned enterprises. Their sales and pricing were dictated by the state's planning authorities, and their financing and product costing were administered by the state's finance departments. Under this system, the purpose of accounting was to serve the needs of the state for economic planning and control. A uniform set of standardized accounts was developed to integrate information into the national economic plan. The uniform accounting system contained all-inclusive accounting rules that were mandatory for state-owned enterprises across the country.

Financial reporting was frequent and detailed. The main feature was a fund-management orientation where *funds* meant the property, goods, and materials used in the production process. Financial reporting emphasized the balance sheet, which reflected the source and application of funds. It focused on stewardship and accountability, or the fulfilling of production and other goals, as well as compliance with governmental policies and regulations. Accounting emphasized counting quantities and comparing costs and quantities. Although accounting focused more on managerial than financial objectives, its role in decision-making by the managers of individual enterprises was nevertheless subordinated to the central authorities.

China's economy today is best described as a hybrid economy in which the state controls strategic commodities and industries, while other industries, as well as the

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[42] The Chinese economy is now the fourth-largest in the world, after the United States, Japan, and Germany. A central feature of China's reforms is a gradualist approach to economic liberalization. See Robert J. Barro, "China's Slow Yet Steady March to Reform, *Business Week* (September 30, 2002): 28; Fareed Zakaria, "The Big Story Everyone Missed," *Newsweek* (January 6, 2003): 52.

commercial and private sectors, are governed by a market-oriented system.[43] The recent economic reforms involve privatizations, including the conversion of state-owned enterprises into share-issuing corporations. New accounting rules have had to be developed for newly privatized companies and other independent limited liability companies, as well as for foreign business entities, such as joint ventures. The role of the government has been changing from managing both the macro- and microeconomy to one managing at the macro level only.[44] Accounting standards were needed to reflect this new reality.

ACCOUNTING REGULATION AND ENFORCEMENT The Accounting Law, last amended in 2000, covers all enterprises and organizations, including those not owned or controlled by the state. It outlines the general principles of accounting and defines the role of the government and the matters that require accounting procedures. The State Council (an executive body corresponding to a cabinet) has also issued Financial Accounting and Reporting Rules for Enterprises (FARR). These focus on bookkeeping, the preparation of financial statements, reporting practices, and other financial accounting and reporting matters. FARR apply to all enterprises other than very small ones that do not raise funds externally. The Ministry of Finance, supervised by the State Council, formulates accounting and auditing standards. Besides accounting and auditing matters, the ministry is responsible for a wide range of activities affecting the economy. Generally, these activities include formulating long-term economic strategies and setting the priorities for the allocation of government funds. More specifically, the ministry's responsibilities include:

- formulating and enforcing economic, tax, and other finance-related policies
- preparing the annual state budget and fiscal report
- managing state revenue and expenditure
- developing the financial management and tax system[45]

Accounting and auditing matters fall into the last category.

In 1992 the Ministry of Finance issued Accounting Standards for Business Enterprises (ASBE), a conceptual framework designed to guide the development of new accounting standards that would eventually harmonize domestic practices and harmonize Chinese practices with international practices. The ASBE was a landmark event in China's move to a market economy. Before the ASBE, more than 40 different uniform accounting systems were in use, varying across industries and types of ownership. Although each one of these could individually be labeled as *uniform*, taken together they resulted in inconsistent practices overall. Thus, one motive for issuing the ASBE was to harmonize domestic accounting practices. Moreover, existing practices were incompatible with international practices and unsuited for a market-oriented economy. Harmonizing Chinese accounting

[43] State-owned enterprises dominate key sectors, such as banking, telecoms, energy, and the media. Non-state-owned enterprises now produce two-thirds of China's manufacturing output.

[44] The ownership relationship between the government and state-owned enterprises has been redefined. Regulations issued by the Ministry of Finance in 1994 announced for the first time that the state is an investor in the enterprise and is responsible for the enterprise's debts limited to the amount of its capital; the enterprise has its own legal status, enjoying its own property rights and bearing independent civil responsibilities. See Zezhong Xiao and Aixiang Pan, "Developing Accounting Standards on the Basis of a Conceptual Framework by the Chinese Government," *International Journal of Accounting* 32, no. 3 (1997): 282. For further discussion of China's reforms of state-owned enterprises, see "The Longer March," *Economist* (September 30, 2000): 71–73. China has 120,000 state-owned enterprises.

[45] "Role of the Ministry of Finance," Ministry of Finance Web site (www.mof.gov.cn), December 16, 2000.

to international practices served to remove barriers of communication with foreign investors and helped meet the needs of the economic reforms already under way.

After the issuance of the ASBE, the Ministry of Finance replaced the more than 40 uniform accounting systems mentioned previously with 13 industry-based and two ownership-based accounting systems. These systems were viewed as transitional until specific accounting standards could be promulgated that would apply to all enterprises operating in China. A revised ASBE was issued in 2001.

The China Accounting Standards Committee (CASC) was established in 1998 as the authoritative body within the Ministry of Finance responsible for developing accounting standards.[46] The standard-setting process includes assigning necessary research to task forces, the issuance of exposure drafts, and public hearings. CASC members are experts drawn from academia, accounting firms, government, professional accounting associations, and other key groups concerned with the development of accounting in China. After it was formed, the CASC began issuing standards on such issues as the cash flow statement, debt restructuring, revenue, nonmonetary transactions, contingencies, and leases. All of these standards were aimed at converging Chinese accounting standards with International Financial Reporting Standards.

Finally, in 2006, in a Big Bang approach to convergence, a new set of Accounting Standards for Business Enterprises was issued. This new ASBE consists of one basic ASBE and 38 specific ASBE. The basic standard established the framework, and the specific standards set out broad principles and detailed implementation guidance on such areas as fixed and intangible assets, inventories, leases, income taxes, consolidations, and segment reporting. Together they represent a comprehensive set of Chinese accounting standards that are substantially in line with IFRS. The new ASBE applies to all Chinese companies (except small ones), phasing out the industry and ownership standards referred to above. Exhibit 4-4 summarizes the basic ASBE. Forty-eight new auditing standards, similar to the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (see Chapter 8), were issued at the same time. All Chinese accounting firms and CPAs are required to follow these audit standards.

The China Securities Regulatory Commission (CSRC) regulates China's two stock exchanges: Shanghai, which opened in 1990, and Shenzhen, which opened in 1991.[47] It

EXHIBIT 4-4 **China's Accounting Standards for Business Enterprises—Basic Standard**

- **General provisions:** stewardship, economic decision-making, going concern, accrual basis.
- **Qualitative requirements of accounting information:** faithful representation, relevance, understandability, comparability, substance over form, prudence.
- **Definitions of elements:** assets, liabilities, owners' equity, revenue, expenses, profit.
- **Accounting measurement:** Generally, historical cost; if elements are measured at replacement cost, net realizable value, present value, or fair value, the enterprise shall ensure that such amounts are available and can be reliably measured.
- **Financial reports:** balance sheet, income statement, cash flow statement, and notes.

[46] The CASC Web site is www.casc.gov.cn.
[47] The CSRC Web site is www.csrc.gov.cn.

sets regulatory guidelines, formulates and enforces market rules, and authorizes initial public offers and new shares. A code of corporate governance was introduced in 2002. The CSRC also issues additional disclosure requirements for listed companies. Thus, disclosure requirements for listed companies are established by two government bodies, the Ministry of Finance and the CSRC.[48]

Until 1995 China had two professional accounting organizations. The Chinese Institute of Certified Public Accountants (CICPA), established in 1988 under the jurisdiction of the Ministry of Finance, regulated the audit of private-sector enterprises. The Chinese Association of Certified Public Auditors (CACPA) was responsible for auditing state-owned enterprises and was under the authority of a separate agency, the State Audit Administration. In 1995 CICPA and CACPA merged, keeping the name of the CICPA. The CICPA sets the requirements for becoming a CPA, administers the CPA examination, develops auditing standards, and is responsible for the code of professional ethics.[49]

FINANCIAL REPORTING The accounting period is required to be the calendar year. Financial statements consist of:

1. Balance sheet
2. Income statement
3. Cash flow statement
4. Statement of changes in equity
5. Notes

Additional statements are required disclosing asset impairments, changes in capital structure, appropriations of profits, and business and geographical segments. The notes include a statement of accounting policies. As applicable, they discuss such matters as contingencies, important post-balance sheet events, and related-party transactions. A management discussion and analysis is required discussing the enterprise's operations, financial position, results, cash flows, and items affecting them. Financial statements must be consolidated, comparative, in Chinese, and expressed in the Chinese currency, the renminbi. The annual financial statements must be audited by a Chinese CPA. Listed companies must assess their internal controls and engage an

[48] China's stock markets rank second in the world in terms of market capitalization. Around 1,500 companies are listed, and there are officially nearly 70 million individual investors. Nevertheless, the state holds roughly two-thirds of the shares of listed companies, meaning that two-thirds of the market capitalization is not traded. Most companies are listed for political rather than economic reasons, and almost all of them benefit from government favoritism. Since the state is the dominant shareholder of most listed companies, there are few incentives for managers to maximize shareholder value, and thus managers have relatively little market discipline. Controlling shareholders tend to engage in related-party transactions that are not in the interest of minority shareholders. (China has a *guanxi* ["relationship"] culture based on mutuality and mutual duties. *Guanxi* creates obligations for a continual exchange of favors, which in the extreme can lead to corruption.) Disclosures are still poor, and enforcement of market rules is weak. Much of the individual trading is based on rumor rather than reliable information. The stock markets are not yet effective as a way to allocate capital. See "Fools in Need of Institutions," *Economist* (June 30, 2001): 65–66; "Banking on Growth," *Economist* (January 18, 2003): 67–68; "A Survey of Asian Finance: Casino Capital," *Economist* (February 8, 2003): 10–12; P. Lupton, "Corporate Governance and Business Ethics in the Asia-Pacific Region," *Business and Society* (June 2005): 178–210.

[49] China faces a huge shortage of qualified accountants. There are approximately 70,000 bilingual market-oriented accountants trying to do the work of 300,000 to one million. See Katie Hunt, "China: Currency of Change," *Accountancy* (June 2007): 35–36.

external auditor to evaluate the controls and comment on the self-assessment report.[50] A quarterly balance sheet, income statement, and notes are required for listed companies.

ACCOUNTING MEASUREMENTS The purchase method must be used to account for business combinations. Goodwill is the difference between the cost of the acquisition and the fair values of the assets and liabilities acquired. It is tested for impairment on an annual basis. The equity method is used for investments in associates, those over which the investee has significant influence. The equity method is also used to account for joint ventures. All subsidiaries under the control of the parent are consolidated. The financial statements of an overseas subsidiary are translated based on the primary economic environment in which it operates. If it is the local (overseas) environment, the balance sheet is translated at the year-end exchange rate, the income statement is translated at the average-for-the-year exchange rate, and any translation difference is shown in equity. If it is the parent's environment, monetary items are translated at the year-end exchange rate, nonmonetary items are translated at the relevant transaction-date exchange rate, and revenues and expenses are translated at the transaction-date rate (or the appropriate average rate for the period). The translation difference is included in income.

Historical cost is the basis for valuing tangible assets; revaluations are not allowed. They are depreciated over their expected useful lives, normally on a straight-line basis. Accelerated and units-of-production depreciation are also acceptable. FIFO and average are acceptable costing methods, and inventory is written down for price declines and obsolescence. Acquired intangibles are also recorded at cost. Those with a finite life are amortized over the periods benefited based on the pattern in which the benefits are consumed. Intangibles with an indefinite life are not amortized but are impairments tested at least annually. Because land and much of the industrial property in China are owned by the state, companies that acquire the right to use land and industrial property rights show them as intangibles. Assets are revalued when a change in ownership takes place, as when a state-owned enterprise is privatized. Certified asset assessment firms or CPA firms determine these valuations.

Research costs are expensed, but development costs are capitalized if technological feasibility and cost recovery are established. Finance leases are capitalized. Deferred taxes are provided in full for all temporary differences. Employee benefits are expensed as they are earned rather than when paid. Contingent obligations are provided for when they are both probable and their amount can be reliably estimated.

India

India occupies much of the South Asian subcontinent, with Pakistan to the west, China, Nepal, and Bhutan to the north, and Bangladesh to the east. The Himalaya Mountains, the tallest mountain system in the world, are located on India's northern

[50] This requirement is similar to Section 404 of the Sarbanes-Oxley Act discussed in the section on the United States.

border.[51] Coastal India has the Arabian Sea to the west, the Indian Ocean to the south, and the Bay of Bengal to the east. India has 17 percent of the world's population, the second most populous nation in the world after China.[52] India is also one of the most ethnically diverse countries in the world. It is home to several hundred languages, 18 of which have official status. Hindi is the official language and the most widely spoken, but English is widely used in government, business, science, and education.

The people of India have had a continuous civilization for more than 5,000 years. Extensive urbanization based on commerce and agricultural trade appears to have begun in the Indus River Valley (in the northwest) around 3000 B.C. Since this time, numerous empires have ruled various portions of South Asia, often assimilating a rich array of peoples, each adding its own contribution to the region's increasingly diverse cultures, ideas, and technologies. The political map of ancient and medieval India was made up of myriad kingdoms with fluctuating boundaries. In the 4th and 5th centuries A.D., northern India was unified under the Gupta Dynasty. During this period, known as India's Golden Age, science, literature, and the arts flourished under Hindu culture. The south also experienced several great empires. Arab, Turkic, and Afghan Muslims ruled successively from the 8th to the 18th century A.D.[53]

European economic competition in India began soon after the Portuguese arrived in 1498. The first British outpost was established by the East India Company in 1619, and permanent trading stations were opened in other parts of the country over the rest of the 17th century. The British expanded their influence from these footholds until, by the 1850s, they controlled—politically, militarily, and economically—most of present-day India, Pakistan, Sri Lanka, and Bangladesh. A mass campaign against British colonial rule began in the 1920s under the leadership of Mohandas Gandhi and Jawaharlal Nehru. Rising civil disobedience and World War II eventually rendered India too costly and difficult to administer, and the British government granted independence in 1947. British India was immediately partitioned into two separate states: India, with a Hindu majority; and East and West Pakistan—now Bangladesh and Pakistan—with Muslim majorities. The British legacy in India is substantial, including its common law legal system, its parliamentary system of central government, and the widespread use of the English language.

From 1947 to the late 1970s, the Indian economy was characterized by central government socialist-style planning and import-substitution industries. Economic production was transformed from primarily agriculture, forestry, fishing, and textile manufacturing to various heavy industries and transportation. However, the lack of competition contributed to poor product quality and inefficiencies in production. Facing an economic crisis, the government began opening up the economy in 1991.[54] The market-oriented economic reforms adopted since then include the privatization of

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[51] The country's exact size is subject to debate because some of its borders are disputed.

[52] India has 41 cities with more than one million people. It is also a young nation: 30 percent of the world's children are in India.

[53] Hinduism, Buddhism, Jainism, and Sikhism were born in India.

[54] Community and family networks have a long tradition in India and have affected the structuring of businesses. Family-controlled businesses are very common. In general, ownership in Indian companies is concentrated, either by families or the government.

some state-owned industries, liberalized foreign investment and exchange regimes, reductions in tariffs and other trade barriers, reform and modernization of the financial sector, significant adjustments in government monetary and fiscal policies, and safeguarding intellectual property rights. However, a large proportion of heavy industry is still state-owned, and high tariffs and limits on foreign direct investment are still in place.[55] The services sector has proved to be India's most dynamic sector in recent years, with telecommunications and information technology recording particularly rapid growth.[56]

Future economic growth is constrained by an inadequate infrastructure, a cumbersome bureaucracy and red tape, labor market rigidities, and corruption. The lack of reliable and affordable infrastructure, especially roads and electricity, is viewed by many as the single most important brake on future growth. Red tape also imposes heavy costs on business in many parts of the country—for example, in bribes paid to inspectors.[57] Finally, labor laws impose extra costs.[58] The reforms that began in 1991 have cut away bureaucratic controls and encouraged the creation of a more competitive marketplace. Most observers agree that further reforms and additional investment in infrastructure are needed to make India a leading economic player, but as noted at the beginning of this chapter, the same observers are optimistic about India's growth prospects.

ACCOUNTING REGULATION AND ENFORCEMENT The British influence extends to accounting: Financial reporting is aimed at fair presentation, and there is an independent accounting profession that sets accounting and auditing standards. The two major sources of financial accounting standards in India are companies law and the accounting profession. The first companies act was legislated in 1857, and the first law relating to the maintenance and audit of accounting records was enacted in 1866, along with the first formal qualifications of auditors. Both were based on British law.

The current Companies Act 1956 is administered and updated by a government agency, the Ministry of Company Affairs. The act provides a broad framework for keeping so-called books of account and the requirements for an audit. According to the act, books of account

- must give a true and fair view of the state of affairs of the company
- must be kept on an accrual basis according to the double-entry system of accounting.

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[55] U.S. Department of State, "Background Notes: India" (October 2006), www.state.gov; Library of Congress – Federal Research Division, "Country Profile: India" (December 2004), http://lcweb2.loc.gov/frd/cs/profiles/India.pdf; "Now for the Hard Part: A Survey of India," *Economist* (June 3, 2006): 1–18.

[56] The industry barely existed in India in 1991, when the economic reforms began. It is said that India's telecommunications and information technology sector is successful because it has always competed in a global marketplace. It never benefited from government favors or suffered distorted incentives of government protection. See "Now for the Hard Part: A Survey of India," *Economist* (June 3, 2006): 4.

[57] Priya Basu of the World Bank is quoted as saying, "Entrepreneurs have to spend significant time in dealing with permits, clearances and inspections, and end up paying substantial 'rents' to the inspectors." See *Economist*, "Now for the Hard Part: A Survey of India" (June 3, 2006): 14. The article goes on to say that collusion between contactors and vendors is so common that it is probably not even recognized as corrupt. See also *Economist*, "An Elephant, Not a Tiger" (December 2008): 1–18.

[58] Chapter 5B of the 1947 Industrial Disputes Act prohibits companies with more than 100 employees from laying off workers without the permission of the state government. This law discourages hiring and encourages the substitution of capital for labor in a country that is people rich.

The act requires an audited balance sheet and profit and loss account, approved by the board of directors.[59] An accompanying directors' report must address the state of affairs of the company, its material commitments, recommended dividends, and other information necessary for understanding the nature of the company's business and subsidiaries.

The Institute of Chartered Accountants of India (ICAI), established in 1949, regulates the profession of chartered accountancy and is responsible for developing both accounting and auditing standards.[60] Chartered accountants were previously known as registered accountants and the institute was preceded by other organizations of professional accountants, such as the Society of Auditors, founded in Madras in 1927. The institute prescribes the qualifications for becoming a chartered accountant, holds examinations and training programs for candidates, issues certificates to practice, and disciplines members for professional misconduct and breaches of ethical behavior. Its Accounting Standards Board issues Indian Accounting Standards (AS), and its Auditing and Assurance Standards Board issues Auditing and Assurance Standards (AAS). AS have statutory authority, and AAS are mandatory for the practice of auditing. The institute is supervised by the Ministry of Company Affairs. In 2007, the ICAI announced that it will adopt IFRS in 2011.

There are 22 stock exchanges in India, the oldest of which is the Mumbai (Bombay) Stock Exchange, established in 1875 and now listing more than 6,000 stocks.[61] The regulatory agency that oversees the functioning of stock markets is the Securities and Exchange Board of India (SEBI), an agency of the Ministry of Finance established in 1988 and given statutory authority in 1992. In general, the accounting and disclosure requirements for listed companies are similar to those in the AS.

FINANCIAL REPORTING Financial statements consist of two-year balance sheets, income statements, cash flow statements, and accounting policies and notes. Companies that are not listed are only required to prepare parent-only statements, but listed companies must prepare both consolidated and parent-only statements. Neither a statement of shareholders' equity nor a statement of comprehensive income is required. Financial statements must present a true and fair view, but there is no true and fair override as there is in the United Kingdom. As noted above, the Companies Act requires that a directors' report accompany the financial statements. Companies listed on a stock exchange must also provide a management discussion and analysis covering such topics as the industry structure and development, opportunities and threats faced by the company, internal controls, and risks that affect the performance of business segments or products. Listed companies must also provide interim financial results on a quarterly basis.

ACCOUNTING MEASUREMENTS Subsidiaries are consolidated when the parent owns more than half of the entity's voting power or controls the composition of its board of directors. Subsidiaries may be excluded from consolidation if control is temporary or if there are long-term restrictions on the subsidiary's ability to transfer funds to

[59] As noted later, Indian accounting standards also require a cash flow statement.
[60] The Institute's Web site is www.icai.org.
[61] The combined market capitalization of India's stock exchanges is the eighth largest in the world.

the parent. There are no standards on accounting for business combinations, but most of them are accounted for as a purchase. However, the uniting-of-interests (pooling) method is used for mergers (called amalgamations). Goodwill is the difference between the consideration given and the existing carrying amounts of the assets and liabilities acquired. Practice varies between no amortization of goodwill to amortization over no more than 10 years. Goodwill is also reviewed for impairment. Proportional consolidation is used for jointly controlled entities (joint ventures). The equity method is used to account for associates—entities over which there is significant influence but not control.

Translation of the financial statements of a foreign operation depends on whether it is integral or nonintegral to the operations of the reporting (parent) entity. For integral foreign operations, monetary assets and liabilities are translated at the closing (year-end) exchange rate, nonmonetary items carried at historical cost are translated at the exchange rate at the date of the transaction, and nonmonetary items carried at fair value are translated at the exchange rate when fair value was determined. Income statement amounts are translated at the exchange rate on the date of transaction or weighted average rate for the period. Exchange differences are reported in income. Assets and liabilities of nonintegral foreign operations are translated at the closing exchange rate, income and expense items are translated at the exchange rates at the dates of the transactions, and the resulting exchange difference is accumulated in a foreign currency exchange reserve on the balance sheet. AS have no provisions for subsidiaries in hyperinflationary economies.

Fixed assets are valued at either historical cost or revalued (fair) value. Revaluations must be applied to the entire class of fixed asset, but there is no requirement that revaluations be performed at regular intervals. Depreciation is allocated on a systematic basis over the life of the asset. If assets are revalued, depreciation is based on the revalued amount. Intangible assets are normally amortized over no more than 10 years. Internally generated goodwill or other intangibles (e.g., brand names) are not recognized as assets. Research costs are expensed as incurred, but development costs may be deferred if the technical feasibility of the product or process has been demonstrated and the recoverability of the costs is reasonably certain. Inventory is valued at the lower of cost or net realizable value. FIFO and average are acceptable cost-flow methods.

Finance leases are capitalized at fair market value and depreciated over the life of the lease. Operating leases are expensed on a straight-line basis over the lease term. The costs of employee benefits are accounted for as the employee earns them rather than when they are paid. Contingent losses are provided for when they are probable (likely) and a reasonable estimate of the amount can be made. Deferred taxes are provided for all timing differences. Deferred tax assets and liabilities are not discounted to their present values.

As noted earlier, the Institute of Chartered Accountants of India has announced the adoption of IFRS in 2011. However, adoption will likely be rolled out gradually, with the largest Indian companies adopting IFRS in 2011 and the rest of them implementing IFRS by 2014.

Exhibit 4-5 summarizes the significant accounting practices in the countries surveyed in this chapter.

EXHIBIT 4-5 **Summary of Significant Accounting Practices**

	United States	Mexico	Japan	China	India
1. Business combinations: purchase or pooling	Purchase	Purchase	Purchase	Purchase	Both
2. Goodwill	Capitalize and impairments test	Capitalize and impairments test	Capitalize and amortize; and impairments test	Capitalize and impairments test	Capitalize and amortize; and impairments test
3. Associates	Equity method	Equity method	Equity method	Equity method	Equity method
4. Asset valuation	Historical cost	Historical cost[a]	Historical cost	Historical cost	Historical cost and fair value
5. Depreciation charges	Economic based	Economic based	Tax influenced	Economic based	Economic based
6. LIFO inventory valuation	Permitted	Not used	Permitted[b]	Not permitted	Not permitted
7. Probable losses	Accrued	Accrued	Accrued	Accrued	Accrued
8. Finance leases	Capitalized	Capitalized	Capitalized	Capitalized	Capitalized
9. Deferred taxes	Accrued	Accrued	Accrued	Accrued	Accrued
10. Reserves for income smoothing	No	No	No	No	Some

[a] *Price-level adjusted accounting is used whenever the cumulative three-year inflation rate equals or exceeds 26 percent.*

[b] *Until 2010.*

Discussion Questions

1. Compare and contrast the mechanisms for regulating and enforcing financial reporting in the five countries discussed in this chapter.
2. Compare and contrast the main features of financial reporting in the five countries discussed in this chapter.
3. Auditor oversight bodies have recently been established in several countries discussed in this chapter. Identify the auditor oversight bodies discussed in the chapter. What is the reason for this recent trend?
4. What is the difference between principles-based and rules-based accounting standards? What evidence indicates that U.S. GAAP is rules-based?
5. U.S. financial statements "present fairly," while U.K. financial statements are "true and fair." What is the difference between these two concepts?
6. Mexican companies traditionally guarded their information and were secretive in their financial reporting. What evidence is there that Mexican companies are becoming less secretive?
7. What was the reason for Japan's Big Bang, and what changes in accounting practice have resulted from it?
8. What important features of accounting and reporting are necessary to develop an efficient stock market with fair trading? How likely is it that China will develop such a stock market? Why do you say so?
9. China's aim is to develop accounting standards that are harmonized with international practices. Cite some examples indicating that Chinese accounting standards are consistent with "world-class" practices.
10. What evidence is there of British influence on accounting in India?

Exercises

1. This chapter provides synopses of national accounting practice systems in five countries.

   Required:
   For each country, list:
   a. The name of the national financial accounting standard-setting board or agency.
   b. The name of the agency, institute, or other organization charged with supervising and enforcing financial accounting standards.
2. The International Federation of Accountants (IFAC) is a worldwide organization of professional accounting bodies. IFAC's Web site (www.ifac.org) has links to accounting bodies around the world.

   Required: Visit IFAC's Web site. List the accounting organizations discussed in this chapter that are linked to IFAC's Web site.
3. Reread Chapter 4 and its discussion questions.

   Required:
   a. As you go through this material, prepare a list of five expressions, terms, or short phrases unfamiliar or unusual in your home country.
   b. Write a concise definition or explanation of each item.
4. Analyze the five national accounting practice systems summarized in the chapter.

   Required:
   a. For each of the five countries treated in the chapter, select the most important financial accounting practice or principle at variance with international norms.
   b. For each selection you make, briefly state your reasons for including it on your list.
   c. How does this variance affect reported earnings and the debt-to-asset ratio?
   d. How likely is it that an analyst could adjust for this variance to achieve an "apples to apples" comparison with companies from other countries?
5. Refer to Exhibit 4-5.

   Required: Which country's GAAP appears to be the most oriented toward equity investors? Which country's GAAP appears to be the least oriented toward equity investors? Why do you say so?
6. The United Kingdom and the United States have a common accounting heritage and are

linked by history and language. The term *Anglo-American accounting* is sometimes used to denote their accounting styles because of the similarities in orientation, purpose, and approach. Nonetheless, accounting differences still exist between these two countries.

Required:

a. Identify the major differences between U.K. and U.S. accounting that are discussed in Chapter 3 and this chapter.
b. Which country is likely to be systematically more conservative in measuring reported earnings? Why do you think so?

7. The following describes Japanese accounting before the Big Bang:

> The preparation of consolidated financial statements is based on the Securities and Exchange Law. Individual-company accounts are the basis for the consolidated statements, and normally the same principles are used at both levels. Subsidiaries are consolidated if a parent directly or indirectly owns more than 50 percent of the shares. (However, Japanese regulations have materiality tests that can lead to the exclusion of significant subsidiaries in consolidation.) The purchase method of accounting for business combinations is normally used for business combinations. Goodwill is measured on the basis of the book value of the net assets acquired, not the fair market value as is common in most other countries. Goodwill is amortized over five years. The equity method is used in consolidated statements for investments in nonconsolidated subsidiaries and 20 percent- to 50 percent-owned affiliated companies, but the cost method is used in individual company statements. The equity method is also used to account for joint ventures; proportional consolidation is not allowed. Under the foreign currency translation standard, assets and liabilities of foreign subsidiaries are translated at the current (year-end) exchange rate, revenues and expenses at either the year-end or average rate, and translation adjustments are carried as an asset or liability on the balance sheet.
>
> Accounting measurements based on historical cost are pervasive. Inventory may be valued at cost or the lower of cost or market; cost is most often used. However, in the event of a significant and permanent decline in value, inventory must be written down to market. FIFO, LIFO, and average are all acceptable cost-flow methods, with average the most popular. Fixed assets are valued at cost and depreciated in accordance with the tax laws.
>
> Research and development costs may be capitalized if they relate to new products or techniques, the exploitation of resources, or the development of markets. When capitalized, research and development is amortized over five years. Finance leases, those transferring the risks and rewards of ownership to the lessee, are capitalized, while lease payments on operating leases are charged to income when incurred.
>
> Deferred taxes are not provided for (or needed) in individual company accounts. They are permitted in consolidated financial statements, but normally not provided there, either. Contingent losses are provided for when they are probable and can be reasonably estimated. Tax regulations limit the deductibility of employee retirement and severance benefits to 40 percent of the amount and so are normally only accrued up to this amount. Pension costs are expensed as paid, and unfunded obligations are not accrued. Legal reserves are required: Each year a company must allocate an amount equal to at least 10 percent of cash dividends and bonuses paid to directors and statutory auditors until the legal reserve reaches 25 percent of capital stock.

Required: Identify the major changes that have occurred in Japanese accounting since the Big Bang.

8. The following describes Chinese accounting in the late 1990s:

Financial statements consist of the balance sheet, income statement, statement of changes in financial position (or cash flow statement), notes, and supporting schedules. Consolidated financial statements are required. The purchase method must be used to account for business combinations, and goodwill is amortized over the period benefited. The equity method is used when ownership of another enterprise exceeds 25 percent. When ownership exceeds 50 percent, the accounts of the subsidiary are consolidated. For overseas subsidiaries, the balance sheet is translated at the year-end exchange rate, the income statement is translated at the average-for-the-year exchange rate, and any translation difference is shown as a reserve in equity.

Accounting measurements sometime have a tax orientation. For example, straight-line depreciation is used because tax laws specify this method. Tax law is also referred to in specifying the useful lives of assets and salvage value. Compared to international practice, historical cost is more strictly adhered to and the principle of conservatism is practiced on a more limited basis. These practices also reflect a tax law influence. For example,

1. The lower of cost or market inventory valuation method is not allowed.
2. Provisions for bad debts are allowed only up to 3 percent of the receivables balance.
3. Long-term investments are not written down for permanent declines in value.

Historical cost is the basis for valuing tangible assets. FIFO, average, and LIFO are acceptable costing methods. Acquired intangibles are also recorded at cost and amortized over the periods benefited. Since land and much of the industrial property in China is owned by the state, companies that acquire the right to use land and industrial property rights show them as intangibles.

Costs associated with research and development can be capitalized in some circumstances. Guidance is neither provided on accounting for capital versus operating leases, nor for deferred taxes. Contingent losses are not accrued; however, contingency funds may be set up as appropriations of retained earnings. Reserves for future expansion may also be appropriated out of retained earnings.

Required: Identify the major changes that have occurred in Chinese accounting since the 1990s.

9. Accounting standard setting in most countries involves a combination of private- and public-sector groups. The private sector includes the accounting profession and other groups affected by the financial reporting process, such as users and preparers of financial statements and organized labor. The public sector includes government agencies, such as tax authorities, ministries responsible for commercial law, and securities commissions. The stock market is another potential influence.

Required: Complete a matrix indicating whether each of these groups significantly influences accounting standard setting in the five countries discussed in this chapter. List the groups across the top and the countries down the side; indicate the influence of each group with a yes or no.

10. The following are financial ratios used by analysts:

- *Liquidity*: current ratio; cash flow from operations to current liabilities
- *Solvency:* debt to equity; debt to assets
- *Profitability:* return on assets; return on equity

Required: Assume that you are comparing the financial ratios of companies from two countries discussed in this chapter. Discuss how the accounting practices identified in Exhibit 4-5 would affect your comparisons for each of the six ratios listed.

CASES

Case 4-1

Standing on Principles

Recent U.S. accounting scandals, such as Enron and WorldCom, have caused some to question whether current U.S. generally accepted accounting principles (GAAP) are really protecting investors. Critics, including the U.S. Securities and Exchange Commission (SEC), charge that the rules-based approach to U.S. GAAP encourages a check-the-box mentality that inhibits transparency in financial reporting. Some observers express a preference for principles-based standards, such as International Financial Reporting Standards or those found in the United Kingdom. Both the Financial Accounting Standards Board (FASB) and the SEC have released reports on the feasibility of principles-based accounting standards in the United States.[62]

The following appeared in a leading British professional accounting journal.

> Ever since the Enron debacle first hit the news, smug U.K. accountants have found a new excuse for feeling superior to their transatlantic cousins. The U.S. Financial Accounting Standards Board's massive *oeuvre* have been scoffed at as being merely a whole bunch of rules that don't hang together. Both British and International standards, by way of contrast, are asserted to be based on principles. This essential difference, it is argued, helps to explain why the U.S. profession has got itself into such deep trouble.
>
> Perhaps. But probably not. It certainly seems true that the highly detailed American standards have tended to invite legalistic interpretations and loopholing, whereas the U.K.'s paramount requirement to present a true and fair view has helped to remind us that accounting is more than a compliance activity. However, it is much too glib to characterise their accounting standards as lacking in principle compared to ours; in terms of their intellectual rigour, American accounting standards compare favourably with any others in the world.
>
> How is it that the U.K. and International Accounting Standards Boards appear to have found reliable principles on which to base their own standards, principles that have eluded FASB? After all, both bodies have themselves adopted conceptual frameworks that are largely copies of the FASB's version, and claim to follow them. The answer is that they haven't. Our standards aren't really more principled than the American ones, they are simply less detailed. And even that is changing—both the

[62] Financial Accounting Standards Board, "Proposal: Principles-Based Approach to U.S. Standard Setting," http://www.fasb.org/proposals/principles-based_approach.pdf (October 21, 2002); and Securities and Exchange Commission, "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System," www.sec.gov/news/studies/principlesbasedstand.htm#1f (July 25, 2003).

U.K. and IASB rulebooks have swollen very considerably in recent years, often inspired (if that is the word) by the content of the equivalent American standards.[63]

Required

1. What is the difference between rules-based and principles-based accounting standards, and what are the advantages and disadvantages of each?
2. Why has U.S. GAAP evolved into a rules-based approach? Would principles-based standards be effective in the United States? Why or why not?
3. What needs to change in the United States to make principles-based standards effective?
4. Are investors and analysts better served by rules-based or principles-based accounting standards? Why do you say so?

Case 4-2

Casino Capital

What conditions are necessary to develop an efficient stock market with fair trading? What role does accounting and financial reporting play in stock market development? Consider the case of China:

Those Chinese who think of themselves as street-smart tell a joke about three fools. The first is the boss who plays around with his secretary and ends up her husband. The second is the investor who plays the property market and ends up a homeowner. And the third is the punter who plays the stock market and finds himself a shareholder. This sums up the culture of China's fledgling capital markets. "Trading, not ownership," is the approach of China's investors, says Anthony Neoh, a former head of Hong Kong's Securities and Futures Commission who is now the chief outside adviser to China's regulatory body. "That's what we need to change."

This marks a shift in China's capital market reforms. So far, Beijing has focused almost entirely on the "supply side" of the securities market. This has included listing more, and better, companies, and forcing them to adopt better standards of corporate governance and disclosure. Such efforts have a long way to go.

However, the government now realizes that it also needs to work on the "demand side." At present, China's stock market, Asia's second-largest by capitalization, consists of 60m mainly clueless retail investors, driven to trade almost entirely on rumor.[64]

[T]he balance sheets of Chinese companies are, by common consent, a joke. In January [2001] the government's official auditing body admitted that more than two-thirds of the 1,300 biggest state-owned enterprises cook their books. Johnny Chen, the Beijing head of PricewaterhouseCoopers, says that even

[63] Ron Paterson, "A Matter of Principle," *Accountancy* (February 2003): 98.
[64] "Fools in Need of Institutions," *Economist* (June 30, 2001), p. 65.

this is an understatement. Quite simply, the SOEs' numbers are whatever the key man wants them to be. And without genuinely independent directors to chair an audit committee, that will not change.[65]

Even China's mostly hapless stock market investor (66m of them, officially) had something to cheer about this month, after the country's highest court said that shareholders could file individual or class action lawsuits against companies that lie about their accounts. There appear to be a lot of liars about. Around 900 shareholder suits are pending, in a country with 1,200 listed companies.

It remains to be seen whether these steps amount to mere tinkering, or herald the new and bolder approach to financial reform that China badly needs. Its markets for labor, goods, and services are nowadays more liberal than those in some capitalist economies. Its capital markets, by contrast, have changed only cosmetically since the days of central planning. In effect, all capital in China is allocated, one way or the other, by the government, which wastes much of it.

The decade-old stock market is dominated by state-owned enterprises that were listed for political rather than economic reasons. Some two-thirds of the market's capitalization is not traded, so the state retains total control. There is no corporate bond market to speak of.[66]

[A]ll is not what it seems in China's capital markets. For a start, growth in the domestic stock market has outstripped the efforts—game as they are—of the regulators and the legal system to police it. The authorities say that computer matching of share transactions has allowed them pretty much to stop powerful syndicates ramping up share prices. They have even sent the biggest manipulators to jail, yet insider trading is still rife on a heroic scale. Stock exchange executives reckon that the real number of investors is around half the official number: investors use multiple accounts for dodgy share dealings.

The real issue is the quality of the listed companies themselves, says one financial official. Even some of the better-regarded ones indulge in all sorts of market abuses, such as lending money raised on the stock market to the parent company rather than investing it, or speculating in the stock market on their own account. Almost all companies allowed a listing are the beneficiaries of government favoritism. Their profitability is usually abysmal, their levels of disclosure poor, and—with the state holding roughly two-thirds of the shares of companies listed in Shanghai and Shenzhen—their treatment of minority shareholders appalling.[67]

[T]he biggest problem is the poor quality of the listed companies. All but a handful are state enterprises, which are approved for an IPO by a political committee rather than by independent underwriters. A 2002 survey by the China Securities Regulatory Commission (CSRC), the top regulator, found that one in ten listed companies had doctored its books, and the finance ministry reported in January [2004] 152 firms it had surveyed had misstated their profits by a combined 2.9 billion yuan. "The stock market has been used to support national

[65] "Survey: Asian Business," *Economist* (April 7, 2001), p. 13.
[66] "Banking on Growth," *Economist* (January 18, 2003), p. 67.
[67] "A Survey of Asian Finance," *Economist* (February 8, 2003), pp. 10–11.

industrial policy, to subsidize SOE restructuring, not to allow private companies to raise capital," says Stephen Green of the Royal Institute of International Affairs.[68]

Required

1. Describe the conditions necessary to develop a stock market in an emerging economy.
2. How do these conditions compare to the situation in China?
3. How likely is China to develop a stock market with fair trading? Why do you say so?
4. Outline a plan of reforms necessary to achieve stock market development in China.

[68] "Behind the Mask: A Survey of Business in China," *Economist* (March 20, 2004): 19.