EVIDENCE OF ACCOUNTING DIVERSITY

Some of the differences in accounting that exist across countries can be categorized in the following manner:

1. Differences in the financial statements included in an annual report.
2. Differences in the format used to present individual financial statements.
3. Differences in the level of detail provided in the financial statements.
4. Terminology differences.
5. Disclosures differences.
6. Recognition and measurement differences.

REASONS FOR ACCOUNTING DIVERSITY

Why do financial reporting practices differ across countries? Accounting scholars have hypothesized numerous influences on a country's accounting system, including factors as varied as the nature of the political system, the stage of economic development, and the state of accounting education and research. A survey of the relevant literature has identified the following five items as being commonly accepted as factors influencing a country's financial reporting practices: legal system, taxation, providers of financing, inflation, and political and economic ties.

1. Legal System

There are two major types of legal systems used around the world: common law and codified Roman law. Common law began in England and is primarily found in the English-speaking countries of the world. Common law countries rely on a limited amount of statute law, which is then interpreted by the courts. Court decisions establish precedents, thereby developing case law that supplements the statutes. A system of code law, followed in most non-English-speaking countries, originated in the Roman *jus civile* and was developed further in European universities during the Middle Ages. Code law countries tend to have relatively more statute or codified law governing a wider range of human activity. What does a country's legal system have to do with accounting? Code law countries generally have corporation law (sometimes called a commercial code or companies act), which establishes the basic legal parameters governing business enterprises. The corporation law often stipulates which financial statements must be published in accordance with a prescribed format. Additional accounting measurement and disclosure rules are included in an accounting law debated and passed by the national legislature. In countries where accounting rules are legislated, the accounting profession tends to have little influence on the development of accounting standards.

In countries with a tradition of common law, although a corporation law laying the basic framework for accounting might exist (such as in the United Kingdom), specific accounting rules are established by the profession or by an independent nongovernmental body representing a variety of constituencies. Thus, the type of legal system in a country tends to determine whether the primary source of accounting rules is the government or a nongovernmental organization.

In code law countries, the accounting law tends to be rather general and does not provide much detail regarding specific accounting practices and may provide no guidance at all in certain areas. Germany is a good example of this type of country. The German accounting law passed in 1985 is only 47 pages long and is silent with regard to issues such as leases, foreign currency translation, and cash flow statements.

When no guidance is provided in the law, German companies refer to other sources, including tax law, opinions of the German auditing profession, and standards issued by the German Accounting Standards Committee, to decide how to do their accounting. Interestingly enough, important sources of accounting practice in Germany have been textbooks and commentaries written by accounting academicians.

In common law countries, where there is likely to be a non-legislative organization developing accounting standards, much more detailed rules are developed. In Nigeria, we used to have the Nigerian Accounting Standards Board (NASB), which has been replaced by the Financial Reporting Council of Nigeria (FRCN); while they have the Financial Accounting Standards Board (FASB) in the United States, which provides a substantial amount of implementation guidance in its accounting standards codification (ASC) and updates.

2. Taxation

In some countries, published financial statements form the basis for taxation, whereas in other countries, financial statements are adjusted for tax purposes and submitted to the government separately from the reports sent to stockholders. Continuing to focus on Germany, the so-called congruency principle (Massgeblichkeitsprinzip) in that country stipulates that the published financial statements serve as the basis for taxable income. In most cases, for an expense to be deductible for tax purposes it must also be used in the calculation of financial statement income. Well-managed German companies attempt to minimize income for tax purposes, for example, through the use of accelerated depreciation, so as to reduce their tax liability. As a result of the congruency principle, accelerated depreciation must also be taken in the calculation of accounting income. In the United States, in contrast, conformity between the tax statement and financial statements is required only with regard to the use of the last-in, first-out (LIFO) inventory cost flow assumption. U.S. companies are allowed to use accelerated depreciation for tax purposes and straight-line depreciation in the financial statements. All else being equal, because of the influence of the congruency principle, a German company is likely to report lower income than its U.S. counterpart. The difference between tax and accounting income gives rise to the necessity to account for deferred income taxes, a major issue in the United States as well as in Nigeria. Deferred income taxes are much less of an issue in Germany; for many German companies, they do not exist at all. This is also true in other code law countries such as France and Japan.

3. Providers of Financing

The major providers of financing for business enterprises are family members, banks, governments, and shareholders. In those countries in which company financing is dominated by families, banks, or the state, there will be less pressure for public accountability and information disclosure. Banks and the state will often be represented on the board of directors and will therefore be able to obtain information necessary for decision making from inside the company. As companies become more dependent on financing from the general populace through the public offering of shares of stock, the demand for more information made available outside the company becomes greater. It simply is not feasible for the company to allow the hundreds, thousands, or hundreds of thousands of shareholders access to internal accounting records. The information needs of those financial statement users can be satisfied only through extensive disclosures in accounting reports. There can also be a difference in financial statement orientation, with stockholders more interested in profit (emphasis on the income statement) and banks more interested in solvency and liquidity (emphasis on the balance sheet).

Bankers tend to prefer companies to practice rather conservative accounting with regard to assets and liabilities.

4. Inflation

Countries experiencing chronic high rates of inflation found it necessary to adopt accounting rules that required the inflation adjustment of historical cost amounts. This was especially true in Latin America, which as a region has had more inflation than any other part of the world. For example, throughout the 1980s and 1990s, the average annual rate of inflation rate in Mexico was approximately 50 percent, with a high of 159 percent in 1987. Double- and triple-digit inflation rates render historical costs meaningless. Throughout most of the latter half of the 20th century, this factor primarily distinguished Latin America from the rest of the world with regard to accounting. Adjusting accounting records for inflation results in a write-up of assets and therefore related expenses. Adjusting income for inflation is especially important in those countries in which accounting statements serve as the basis for taxation; otherwise, companies will be paying taxes on fictitious profits.

5. Political and Economic Ties

Accounting is a technology that can be relatively easily borrowed from or imposed on another country. Through political and economic links, accounting rules have been conveyed from one country to another. For example, through previous colonialism, both England and France have transferred their accounting frameworks to a variety of countries around the world. British-style accounting systems can be found in countries as far-flung as Australia and Zimbabwe. French accounting is prevalent in the former French colonies of western Africa. More recently, it is thought that economic ties with the United States have had an impact on accounting in Canada, Mexico, and Israel.

6. Correlation of Factors

Whether by coincidence or not, there is a high degree of correlation between legal system, tax conformity, and source of financing. Common law countries tend to have greater numbers of domestic listed companies, relying more heavily on equity as a source of capital. Code law countries tend to link taxation to accounting statements and rely less on financing provided by shareholders.

PROBLEMS CAUSED BY ACCOUNTING DIVERSITY

1. **Preparation of Consolidated Financial Statements**

The diversity in accounting practice across countries causes problems that can be quite serious for some parties. One problem relates to the preparation of consolidated financial statements by companies with foreign operations. Consider General Motors Corporation, which has subsidiaries in more than 50 countries around the world. Each subsidiary incorporated in the country in which it is located is required to prepare financial statements in accordance with local regulations. These regulations usually require companies to keep books in local currency using local accounting principles. Thus, General Motors de Mexico prepares financial statements in Mexican pesos using Mexican accounting rules and General Motors Japan Ltd. prepares financial statements in Japanese yen using Japanese standards. To prepare consolidated financial statements in the United States, in addition to translating the foreign currency financial statements into U.S. dollars, the parent company must also convert the financial statements of its foreign operations into U.S. GAAP. Each foreign operation must either maintain two sets of books prepared in accordance with both local and U.S. GAAP or, as is more common, reconciliations from local GAAP to U.S. GAAP must be made at the balance sheet date. In either case, considerable effort and cost are involved; company personnel must develop an expertise in more than one country's accounting standards.

2. **Access to Foreign Capital Markets**

A second problem caused by accounting diversity relates to companies gaining access to foreign capital markets. If a company desires to obtain capital by selling stock or borrowing money in a foreign country, it might be required to present a set of financial statements prepared in accordance with the accounting standards in the country in which the capital is being obtained. To have stock traded in a country, foreign companies must either prepare financial statements using the country's accounting standards or provide a reconciliation of local GAAP net income and stockholders' equity to the country's GAAP. This can be quite costly. In preparing for a New York Stock Exchange (NYSE) listing in 1993, the German automaker Daimler-Benz estimated it spent $60 million to initially prepare U.S. GAAP financial statements; it expected to spend $15 million to $20 million each year thereafter.

3. **Comparability of Financial Statements**

A third problem relates to the lack of comparability of financial statements between companies from different countries. This can significantly affect the analysis of foreign financial statements for making investment and lending decisions. The job of deciding which foreign company to invest in is complicated by the fact that foreign companies use accounting rules different from those used in Nigeria and those rules differ from country to country. It is very difficult if not impossible for a potential investor to directly compare the financial position and performance of an automobile manufacturer in Germany (Volkswagen), Japan (Nissan), and the United States (Ford) because these three countries have different financial accounting and reporting standards. According to Ralph E. Walters, former chairman of the steering committee of the International Accounting Standards Committee, "either international investors have to be extremely knowledgeable about multiple reporting methods or they have to be willing to take greater risk." A lack of comparability of financial statements also can have an adverse effect on corporations when making foreign acquisition decisions. In many cases, the international public accounting firms were called on to convert financial statements to a Western basis before acquisition of a company could be seriously considered.

4. Lack of High-Quality Accounting Information

A fourth problem associated with accounting diversity is the lack of high-quality accounting standards in some parts of the world. There is general agreement that the failure of many banks in the 1997 East Asian financial crisis was due to three factors: a highly leveraged corporate sector, the private sector's reliance on foreign currency debt, and a lack of accounting transparency. To be sure, inadequate disclosure did not create the East Asian meltdown, but it did contribute to the depth and breadth of the crisis. As Rahman explains: "It is a known fact that the very threat of disclosure influences behaviour and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks in the crisis-hit countries." International investors and creditors were unable to adequately assess risk because financial statements did not reflect the extent of risk exposure due to the following disclosure deficiencies:

- The actual magnitude of debt was hidden by undisclosed related-party transactions and off-balance-sheet financing.
- High levels of exposure to foreign exchange risk were not evident.
- Information on the extent to which investments and loans were made in highly speculative assets (such as real estate) was not available.
- Contingent liabilities for guaranteeing loans, often foreign currency loans, were not reported.
- Appropriate disclosures regarding loan loss provisions were not made.

Because of the problems associated with worldwide accounting diversity, attempts to reduce the accounting differences across countries have been ongoing for over three decades. This process is known as harmonization. The ultimate goal of harmonization is to have one set of international accounting standards that are followed by all companies around the world.