Research report 124

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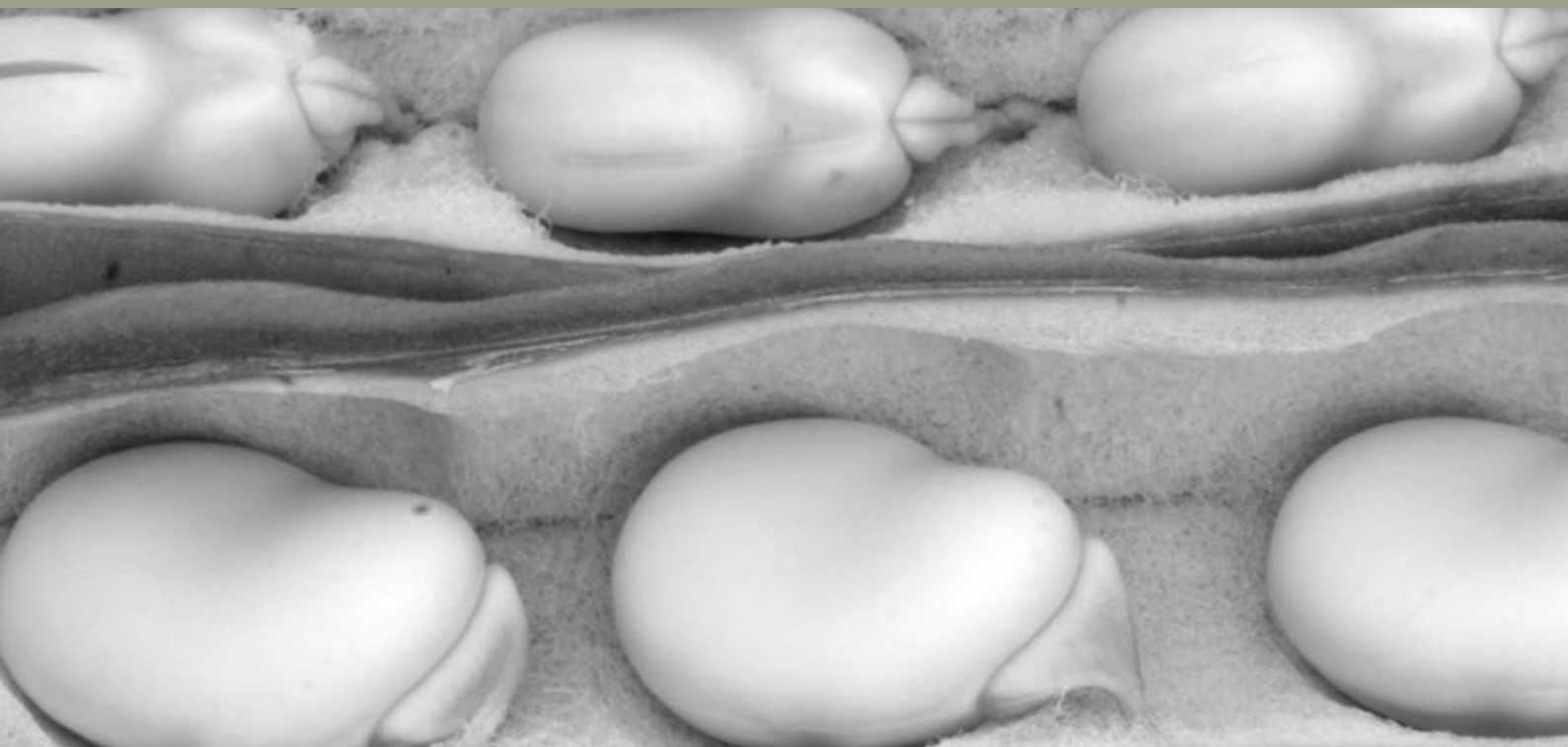
International Variations in IFRS Adoption and Practice



International Variations in IFRS Adoption and Practice

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Certified Accountants Educational Trust (London), 2011

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 Published by Certified Accountants Educational Trust for the Association of Chartered Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE.

ISBN: 978-1-85908-473-1

Contents

Abbreviations

ACCA	Association of Chartered Certified Accountants
AGL	actuarial gains and losses
ASB	Accounting Standards Board
ASX	Australian Stock Exchange index
AVCO	average cost
BRIC	Brazil, Russia, India and China
CAC	French Stock Exchange index
DAX	German Stock Exchange index
DC	dominated culture
EU	European Union
FIFO	first in, first out
FPI	foreign private issuer
FRRP	Financial Reporting Review Panel
FTSE	Financial Times Stock Exchange index
GAAP	generally accepted accounting principles
HGB	Handelsgesetzbuch (German Commercial Code)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBEX	Iberian Stock Exchange index
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
JV	joint venture
LIFO	last in, first out
OCI	other comprehensive income
PPE	property, plant and equipment
SCE	statement of changes in equity
SEC	Securities and Exchange Commission
SMEs	small and medium-sized entities (or enterprises)
SORIE	statement of recognised income and expense
SSAP	Statement of Standard Accounting Practice
SSC	self-sufficient financial and legal culture

Executive summary

This report is designed to investigate the degree to which financial reporting remains different, by country, even within the area of the world that has apparently adopted International Financial Reporting Standards (IFRS). The differences between countries can be divided into two main types: (i) the degree to which IFRS has been mandated or allowed for particular companies or types of reporting, and (ii) the degree to which the practice of IFRS differs along national lines. These two issues are closely linked because of the underlying forces that have caused the long-running accounting differences between countries.

International differences in financial reporting create problems because many users (eg investment analysts acting for investors in equity or debt) assess companies on a comparative basis internationally. Reconciliations from one set of generally accepted accounting principles (GAAP) to another (especially to US GAAP) were common until 2007, and they revealed significant differences between countries. A standard reporting system for listed companies would address these problems. There would be disadvantages if the whole world had to adopt US GAAP. Therefore, IFRS have been developed instead.

A large number of explanations have been offered for differences in the accounting systems of different countries. One model (suggested by the author) is that, unless one country is dominated by another, a national accounting system will be largely determined by the predominant type of financing and owners of companies (and, therefore, by the predominant users of financial reporting). The model can be used to predict how a country's (or a company's) reporting will change as its corporate financing changes. This is especially relevant for countries in transition from Communism. In addition, it is now clear that one country (and even one company) can use more than one system simultaneously for different purposes.

This report shows that each accounting system can be classed as being one of two main types, on the basis of the differential strength of equity markets. For example, one type of accounting (IFRS or US GAAP) is needed by large listed groups for reporting to international investors; the other type (eg French accounting) is relevant to small private companies for reporting and tax accounting.

The International Accounting Standards Board (IASB) has no authority to impose IFRS on companies, and the reactions of different jurisdictions to IFRS differ greatly. Some have ignored it, some have allowed it; some have required IFRS for some purposes, whereas others have abolished national GAAP in favour of IFRS. Very few jurisdictions have simply imposed IFRS as issued by the IASB, although some countries (eg Canada) do incorporate IFRS into law without amendment. Others make amendments and then insert the result into law. All these methods (apart from simply imposing IFRS) need continual attention from regulators. Divergences from IFRS can emerge, not least in the timing of adoption of amendments and new standards. Auditors do not always report on compliance with 'IFRS as issued by the IASB' even when this is being achieved.

The two-type classification can be used to explain and predict which countries will allow IFRS for unconsolidated reports. In Europe, only those with a history of strong equity markets allow IFRS for this purpose. This is because such countries have tax accounting that is, for many topics, separate from financial reporting. Therefore, IFRS can be used in such countries without upsetting tax calculations.

Several major countries have not yet moved to IFRS even for listed companies – Brazil and Canada are adopting IFRS, at least for listed companies in 2010 and 2011 respectively. It seems unlikely that China or Russia will fully adopt IFRS in the near future. The US might partially adopt IFRS for 2014 or later; Japan possibly for 2016.

Some of the factors that led to pre-IFRS international accounting differences can still influence IFRS practices. For example, there is still scope for tax influence to feed through from non-IFRS unconsolidated statements to IFRS group statements.

There are many opportunities for IFRS practices to differ from company to company or from country to country. For example, different versions of IFRS arise because most countries introduce delays or changes when implementing IFRS; in addition, there are options within IFRS. For several reasons, it can be expected that a company will continue with many of its previous accounting policy choices when it first adopts IFRS. This report lists 13 policy choices and makes predictions about which choices would be made under IFRS in five countries: Australia, France, Germany, Spain and the UK. The actual policy choices made by large listed companies in these five countries for 2005 are then recorded. There is statistically strong evidence that pre-IFRS national practices have continued. The national patterns of IFRS practice are set out in order to help users, preparers and auditors to appreciate the differences and to compare annual reports.

The policies for the same countries and companies are examined again in 2008. The report shows that there had been few policy changes since 2005 and, therefore, the national patterns remain. One major change did occur between 2005 and 2008: Continental companies moved to the UK practice of charging actuarial losses to other comprehensive income (and, incidentally, they therefore had to present a statement of such income).

A classification of countries by their IFRS practices reveals the same two-group model ('Anglo' versus Continental European) as seen in earlier classifications of national practices. The number of IFRS policy changes, from 2005 to 2008, also differs between these two country groupings. Continental companies changed their policies much more extensively after the transition to IFRS than did Anglo ones. No underlying economic justifications could be discerned for the continuing international differences in IFRS policies.

Taking Germany as an example, this report shows that small listed companies choose significantly different IFRS policies from the largest companies. The smaller companies are more inclined to continue their traditional practices.

This report recommends that jurisdictions should consider adopting the IASB's process rather than producing national versions of IFRS. If the latter must be done, then auditors should still be required to give an opinion on 'IFRS as issued by the IASB' where that is the intended result in the jurisdiction. Developing countries with few or no listed companies should consider carefully whether IFRS is appropriate for them.

Analysts and others need to be alert to the opportunities for different practices within IFRS. The report provides analysts and others with a chart of typical IFRS practices by country. The report recommends that the IASB should eliminate most of the available options currently within IFRS.

There are many opportunities for further research. The report's model of the reasons for the development of different accounting methods in different countries could be tested for a larger group of countries. Researchers could also apply, to a wider group of countries, the report's method of classifying countries by methods of IFRS implementation, and they could create a new classification related to the IFRS for SMEs. There is also room for investigation of the quality of translations of IFRS and of the quality of enforcement.

On the matter of the choice of IFRS options by companies, researchers could extend the study to more countries, later years and smaller companies. There might also be ways of studying less obvious variations in IFRS practice, such as impairment calculations.

1. Introduction

1.1 THE DANGERS OF POOR COMMUNICATION

If most investors had stayed within national boundaries (as was the case until the 1970s) the use of national accounting practices would have remained unproblematic. When stock markets became international, however, communication went awry. One drastic solution would have been to make all listed companies use US GAAP.

Reconciliations
That, indeed, was the solution for some purposes. Table 1.1 illustrates this. Until 2007, foreign companies listed on US exchanges were required by the Securities and Exchange Commission (SEC) either to present financial statements using US GAAP or to reconcile numerically their specific national accounting to US GAAP.

Table 1.1 shows the summary reconciliations of Glaxo's shareholders' equity (= net assets). This number is the denominator of profitability or gearing ratios. In the first row of the table, to take an extreme example, those ratios were about 100 times larger under US GAAP compared with UK GAAP.

Table 1.1: GlaxoSmithKline reconciliations of shareholders' equity to US GAAP

	UK £m	IFRS £m	US £m	Difference % change
1995	91		8,168	8,876
1996	1,225		8,153	566
1997	1,843		7,882	328
1998	2,702		8,007	196
1999	3,142		7,230	130
2000	7,517		44,995	+499
2001	7,390		40,107	443
2002	6,581		34,992	432
2003	5,059		34,116	574
2004	5,925		34,042	475
2005		7,570	34,282	353
2006		9,648	34,653	259

Source: compiled from the annual reports of GlaxoSmithKline.

The reconciliations enabled Glaxo to be compared with large US pharmaceutical companies. This improved decision making, lowered risk for investors and lowered the cost of capital in the case of UK companies, as other ACCA reports show (Lee at al. 2008).

In practice, only a very small number of non-US companies were SEC-registered, and therefore few provided these reconciliations. Further, for 2007 and after, the SEC has removed the reconciliation requirement, partly in order to make US exchanges more attractive to foreigners. This saved a lot of work for companies such as Glaxo, but hardly improved the quality of communication:[1] it is no longer known how big the differences are.

Why not go the whole way and impose US GAAP?
As noted above, one drastic solution to the communication problem would be for all listed companies around the world to use US GAAP. Counter-arguments are:

- US GAAP is too complex for most companies
- US GAAP relies too much on detailed rules rather than on principles
- US GAAP is 'wrong' in some areas (for example, by allowing last in, first out (LIFO), and by not defining subsidiaries in terms of actual control)
- US GAAP would be politically unacceptable in many countries.

International standards
From the 1970s onwards, international standards were created to solve some of these problems. National habits are tenacious, however, and it has taken decades for international standards to become widely used. There are three aspects of IFRS that remain national.

- Different countries have taken markedly different approaches to implementing IFRS.
- National versions of IFRS practice have grown up, so that there is still no internationally uniform practice, even where IFRS is used without amendments.
- Monitoring and enforcement of IFRS practice remain the responsibility of national regulators.

This report focuses on the first two items above: different national implementations of IFRS and different national versions of IFRS practice.

1. For example, Ashbaugh and Olsson (2002) show that US GAAP and IFRS numbers have statistically different properties.

Evidence of national or regional quirks (in **bold type** below) can be seen in some splendidly oxymoronic phrases in the report of Glaxo's auditors on the 2009 statements:

> *'we conducted our audit in accordance with International Standards on Auditing* ***(UK and Ireland)****...'*
>
> *'the group financial statements give a true and fair view, in accordance with IFRSs* ***as adopted by the European Union****...'*
>
> *'the group financial statements have been properly prepared in accordance with* ***the Companies Act 2006*** *and* ***Article 4 of the IAS Regulation****...'*

So, the auditing standards are 'international' but also 'UK and Ireland'; the accounting standards are 'international' but also 'EU', and the law requires 'international accounting standards' because of an EU 'Regulation' but it is British as well.

1.2 AIMS OF THIS REPORT

In order to investigate the issues above, this report:

- provides an overview of some of the literature on the reasons for the differences in accounting practices
- extends the application of that literature to Brazil, Russia, India and China (BRIC)
- provides a theory to explain the different ways in which countries have implemented IFRS
- investigates the motives for different national versions of IFRS practice
- clarifies the scope for such different versions within IFRS rules
- investigates whether major listed companies preserved a national pattern of accounting on transition to IFRS in 2005
- investigates whether any national patterns still persist by examining 2008/9 financial reports
- applies these findings to economically important countries that will adopt IFRS in the future.

2. International differences before IFRS

2.1 DEFINING SOME TERMS

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

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

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

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

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

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

2.2 A SIMPLE MODEL

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

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

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

Examples of the financing systems are as follows.

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

Table 2.1: Financing systems

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

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

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

There are two caveats to this.

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

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

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

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

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

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

Table 2.2: The strength of equity markets, 2009

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

Source: Nobes and Parker (2010: 33)

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

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

Table 2.3: Examples of features of the two accounting classes

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

2.3 WHY OTHER FACTORS ARE LESS USEFUL

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

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

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

2.4 COLONIAL INFLUENCE

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

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

2.5 EMPIRICAL EVIDENCE

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

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

2.6 THE MODEL DEVELOPED

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

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

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

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

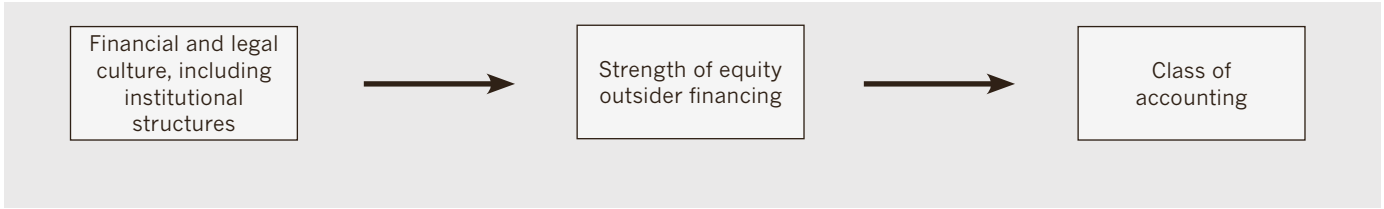
6. The German accounting plan, though copied in France, was abolished by the occupying Western powers after the Second World War. A version survived in communist East Germany until reunification.

7. Doupnik and Salter (1993).

8. Ding et al. (2007).

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

Figure 2.1: Simplified model of reasons for international accounting differences



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

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

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

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

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

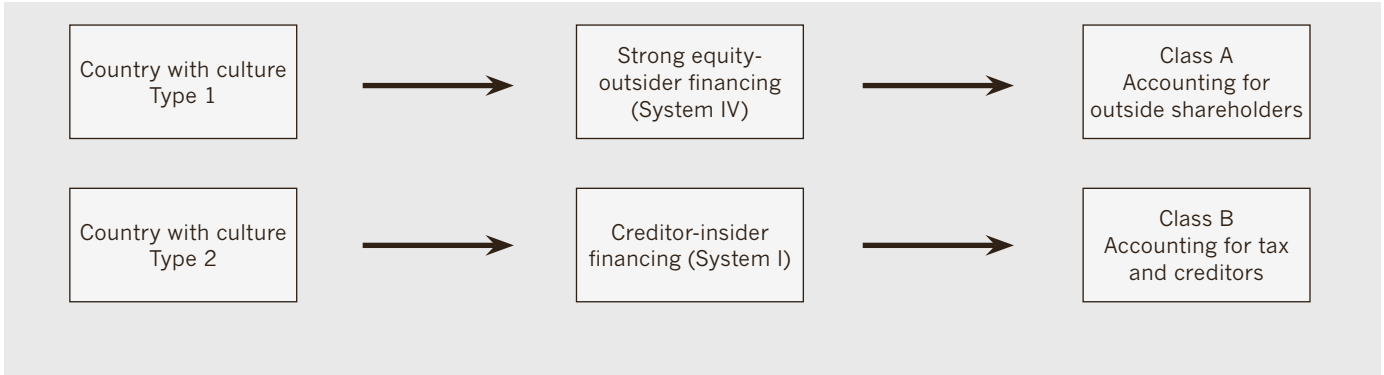
P3: As a country establishes a strong equity-outsider market, its accounting system moves from Class B to Class A.

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

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

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

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



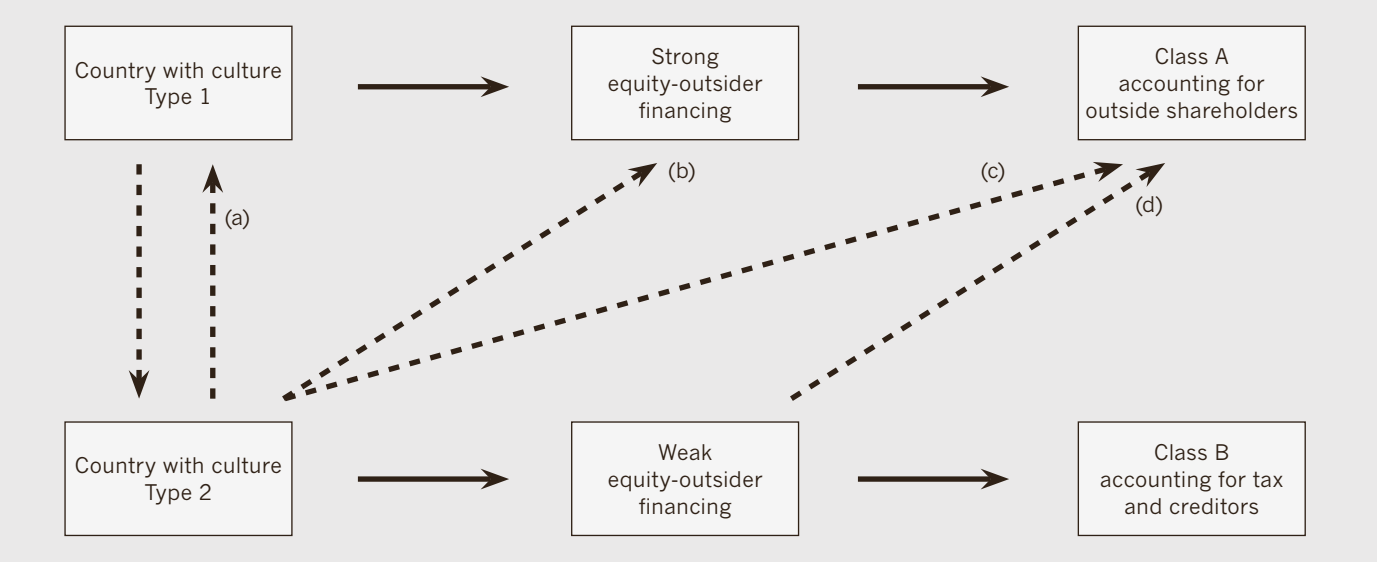
The class into which the predominant accounting system falls will depend upon the strength of the equity-outsider market (or on its strength in the past, if there is inertia). Strong equity-outsider systems will lead to Class A accounting (containing the features in Table 2.3 on page 10) whereas others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

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

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

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

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



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

3. Grouping countries and accounting systems

3.1 INTRODUCTION

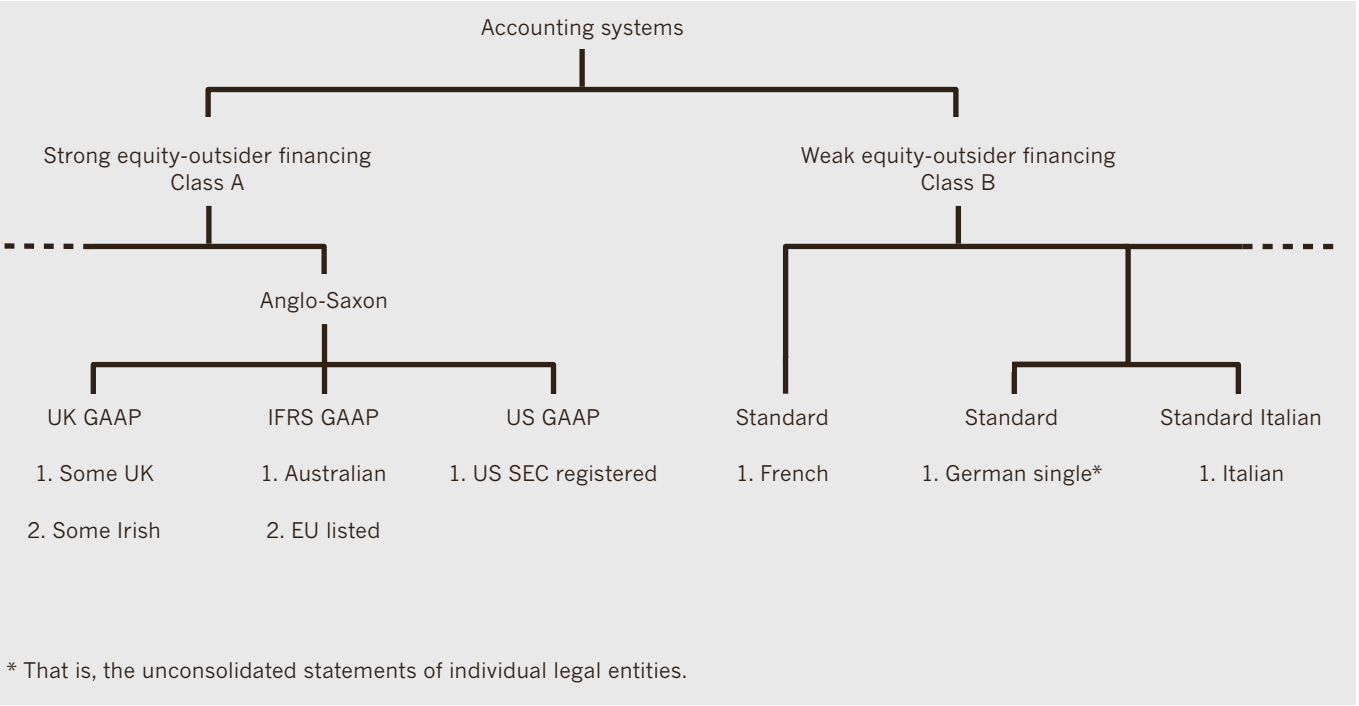
Chapter 2 proposed a two-class model of accounting systems. As recorded there, many researchers have put countries into groups, but that is no longer appropriate because many countries have different accounting systems for different types of financial reporting.

Figure 3.1 suggests an outline classification of accounting systems. On the left, are Class A systems. One family of such systems could be called 'Anglo'. Many people do not like this French-inspired term, but it is a useful short-hand for countries with predominantly English law, English language and British cultural roots.

It is perhaps also controversial to call IFRS 'Anglo-Saxon' but it is surely obvious that the IASB's very nature (part of a private-sector trust), location, language, style of output and conceptual framework place it squarely in that group rather than its being Continental European or South American, for example.

Many Class B systems are Continental European or have their roots there. For example, Japanese and South American accounting systems have mostly French or German roots (despite Iberian colonial influence in South America).

Figure 3.1: An outline classification



* That is, the unconsolidated statements of individual legal entities.

3.2 EUROPE

Later in this report, it will be useful to have a two-group classification of European countries. Using the author's own descriptions of accounting systems (eg Nobes 1997), Table 3.1 classifies some European Union national accounting systems before the arrival of IFRS.

Table 3.1: A two-group accounting classification of some European countries

Class A (strong equity, commercially driven)	Class B (weak equity, government driven, tax-dominated)
Cyprus	Austria
Denmark	Belgium
Ireland	Finland
Malta	France
Netherlands	Germany
Norway	Greece
UK	Italy
	Luxembourg
	Portugal
	Spain
	Sweden
	Switzerland

Note: This table covers the EU (plus Norway and Switzerland) before the expansion of the EU to include former Communist countries that had no 'financial reporting'.

3.3 SOME OTHER COUNTRIES

It would also be easy to classify the pre-IFRS accounting of several other countries that are neither in Figure 3.1 nor Table 3.1. For example:

- South Africa, Singapore and Hong Kong had Class A accounting because of UK influence; and it suited their important equity markets.
- Former British colonies in Africa and the Caribbean had accounting based on former British Companies Acts and standards, even if they had very small equity markets.
- Former or present French colonies have state-controlled, tax-relevant accounting governed by a version of the French accounting plan (*plan comptable général*).

Special consideration is given to the BRIC countries (Brazil, Russia, India and China) in Chapter 5.

4. How countries react to IFRS

4.1 STANDARDISATION

Chapter 1 introduced the idea that standardisation might be helpful for investors who act globally; the reduction of international accounting differences might also be an advantage to multinational companies. Standardisation of the rules of financial reporting involves regulators of different types: rule makers, rule imposers and rule enforcers. It is possible for all three tasks to be carried out by the same agency (eg various branches of the French State for French GAAP). Table 4.1 gives some examples.

Standardisation of the rules can be called de jure standardisation. This is of limited use unless it results in standardisation of practices (de facto). The rest of this report concentrates on de facto harmonisation, particularly as driven by the IASB. As illustrated in Table 4.1, the IASB has no authority to impose IFRS on companies. Regulators of various countries have reacted in many different ways to the availability of IFRS. This chapter investigates this.

Table 4.1: Regulators

	Main rule maker	Imposer	Enforcer
French GAAP	State	State	State
US GAAP	FASB*	SEC	SEC
UK GAAP	ASB*	Companies Act	FRRP*, Court
IFRS in UK	IASB*	EU Regulation	FRRP*, Court

* = private sector body

4.2 A BEWILDERING VARIETY OF METHODS OF IMPLEMENTATION

The IASB (2010) suggests that 'more than 100 countries now require or permit the use of IFRSs or are converging with [them]'. This gives a misleading impression of the prevalence of IFRS, and hides a bewildering array of responses, some of which are described below.

1. Adopting the IFRS process
This is the purest form of IFRS implementation, where the regulations in a jurisdiction require companies to use IFRS as issued by the IASB, whatever these may be at the time. Very few countries have done this, but Israel is one. Even so, this might be done for only some companies (eg listed) or for only some reporting (eg consolidated). For example, South Africa requires listed companies to follow IFRS, but others to follow national GAAP based on IFRS.

2. Inserting IFRS (unchanged in substance) into law
This is another way of implementing IFRS. It might have been the country's traditional way of imposing domestic accounting standards. Compared with method 1, this involves delays in making IFRS available to companies, but it need not mean different dates of compulsory application from the dates of IFRS as issued by the IASB. Canada (from 2011) and South Africa (for unlisted companies) have taken this route. Another possible reason for this response may be because the standards have to be translated from English into a national language (eg Canadian French).

3. Endorsing IFRS
This is the response of the EU. It involves detailed scrutiny of all IFRS output, standard by standard, amendment by amendment. In the case of the EU, many bodies are involved, and the process can take well over one year, running the risk that even the IASB's compulsory application dates will be missed. A worse problem is that whole standards or parts of standards might not be endorsed at all. Famously, part of IAS 39 (on the recognition and measurement of financial instruments) has been 'carved out' (ie parts have been removed).

Another problem is that IFRS 9 (designed eventually to replace IAS 39), issued by the IASB in 2009, can be used in South Africa or Switzerland (from December 2009 year ends) but not in the EU even for 2011, as the EU has not started the process of endorsement. The resulting package of standards cannot be called IFRS: it is 'IFRS as adopted by the EU'. As with any of the other methods of implementing IFRS, not all companies need be covered. For example, the EU Regulation that imposes EU-IFRS for consolidated reporting by listed companies allows member tates to impose, allow or ban IFRS for other purposes.

4. Fully converging with IFRS (and intending compliance)
This method of implementation is used in Australia. The Australian Accounting Standards Board takes the IASB's output and amends it in various ways: giving it an Australian number, making textual changes (eg in relation to public sector entities), banning early adoption, and deleting some options (between 2005 and 2007). The result is clearly not 'IFRS as issued by the IASB' but it is still designed to lead to full compliance with IFRS.

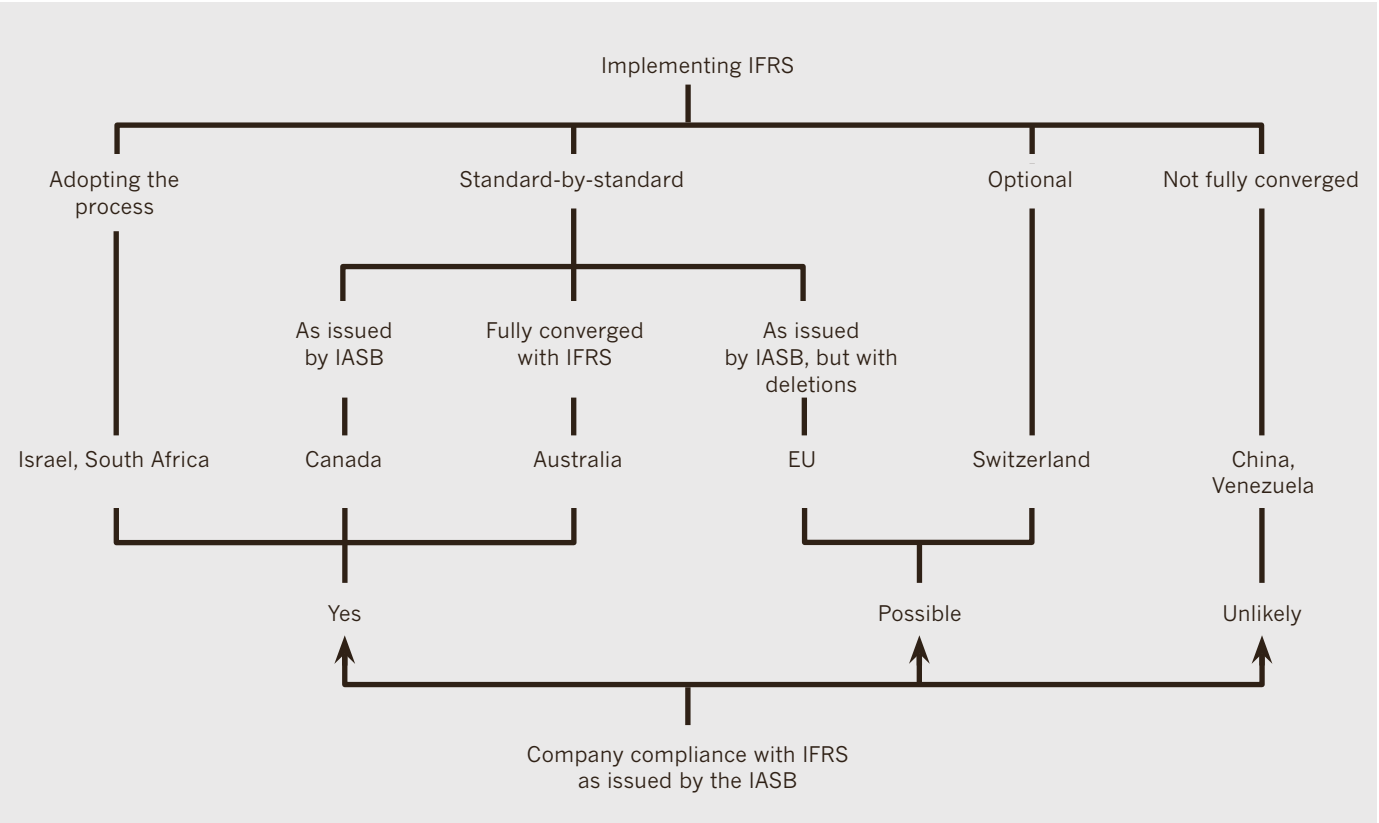
5. Adapting IFRS
A country can take IFRS as a starting point but then make various changes. China has done this. For 2007 onwards, the consolidated statements of Chinese listed companies must use a set of standards based on IFRS. Nonetheless, there are several clear differences. For example, unlike the rule under IAS 36, impairments must never be reversed. Another approach is that of Venezuela, which adopted IFRS en bloc in 2004 but had not (by mid-2011) adopted all the subsequent changes to IFRS.

6. Allowing IFRS
A country can permit companies to use IFRS instead of national GAAP. For example, Switzerland allows certain options for the preparation of consolidated statements by listed companies, one of which is IFRS as issued by the IASB.

Figure 4.1 records these six approaches. In the bottom part of the figure, another point is made: how likely it is that companies in the various countries will comply with IFRS as issued by the IASB. The approaches of South Africa, Israel, Canada and Australia should lead to companies' compliance with IFRS as issued by the IASB; such compliance is possible for EU companies. In 2011, for example, it is merely necessary for a company to deny itself the possibilities for extra hedge accounting allowed by the EU's version of IAS 39. It can then comply with IFRS as issued by the IASB as well as with EU-endorsed IFRS. Most EU companies achieve this, but few point it out. For Swiss listed companies, compliance with IFRS is the norm.

The likely approaches of countries that are yet to implement IFRS (eg India and the US) are considered in section 4.5, after dealing with the issue of how widely IFRS is applied within a country, and in particular, whether or not IFRS is restricted to consolidated statements.

Figure 4.1: Methods of Implementing IFRS (listed companies)



4.3 WHAT THE AUDITORS SAY

In Figure 4.1, companies on the far left (in Israel or South Africa) have audit reports referring to IFRS. Australian audit reports in 2005/7 still referred only to Australian accounting standards, however, even though the financial statements complied with IFRS. This seemed to miss the point of 40 years of effort on international standardisation: helping users (especially those from other countries) to be confident about comparing the financial reports of different companies. Since 2007/8, however, Australian (and New Zealand) auditing standards require reference to IFRS as well as to domestic accounting standards.

In the EU, auditors refer to 'IFRS as adopted by the European Union', which is a warning that there might be differences from 'IFRS as issued by the IASB'. The author has investigated[11] the audit reports of the companies in the main stock market indices[12] of five countries in 2005/6, the first year of IFRS adoption. The five countries (Australia, France, Germany, Spain and the UK) had the largest stock markets that used IFRS, which amounted to 255 companies. At that time, all the Australian audit reports referred to Australian standards only, not to IASB-IFRS as well; whereas all the French and Spanish audit reports only referred to EU-IFRS. By contrast, 22% of the German DAX companies and 17% of the UK FTSE companies had dual audit reports (ie, where the auditors reported separately on compliance with IFRS).

It is likely that nearly all the consolidated statements of EU listed companies that comply with EU-IFRS also comply with IASB-IFRS because, at the time of writing, the only practical differences between the two relate to:

(i) the IAS 39 'carve-out', which has been used by only a few financial institutions, and

(ii) these companies' inability to adopt certain new or amended standards (eg IFRS 9).

So, although their financial statements may in fact comply with IASB-IFRS, EU companies are generally not asking their auditors to signal that they do comply with it.

Table 4.2 shows some information about the 17 UK companies that had dual audit reports. One obvious reason for needing an audit report on IASB-IFRS (at least on documents sent to the SEC) is that the SEC accepts IASB-IFRS but not EU-IFRS from foreign registrants. Table 4.2 (bottom row) shows that 14 of the 17 companies were fully SEC-registered or were otherwise treated as foreign private issuers (FPI) in the United States. Interestingly, the other obvious explanatory factor was that most of the dual reports were provided by Deloitte; the firm stated[13] that it encouraged clients to have such reports.

Table 4.2: UK Dual Audit Reports in 2005/6

Company	Total	SEC registered	Other FPI	Not FPI
Deloitte & Touche	12	5 (2 with 'US Opinion')	5	2
Ernst & Young	3	1	1	1
KPMG	0	0	0	0
PricewaterhouseCoopers	2	1	1	0
Total	17	7	7	3

11. Also published in Nobes and Zeff (2008).

12. Respectively, the ASX 50, CAC 40, DAX 30, IBEX 35, FTSE 100 as at June 2007.

13. Martyn Jones (UK audit technical partner) reports that they had been 'pushing it strongly...from the beginning' (correspondence of 15 January 2008).

4.4 CONFINING IFRS TO CONSOLIDATED STATEMENTS

A proposition

A major proposition can now be made, based on Chapters 2 and 3: strong equity/outsider countries (System IV countries that traditionally used Class A accounting) will require or allow IFRS (or IFRS for SMEs, see section 4.6) for unconsolidated statements; other countries will not. The logic behind this proposition is as follows.

(i) Given that IFRS is a sort of Class A accounting, there is little point in a System IV country maintaining two different Class A accounting systems. So, once IFRS has been adopted for any purpose, it will lead to the immediate or gradual elimination of the national system.

(ii) In Class B countries, national accounting rules had a different purpose from IFRS: that is, to make tax and distribution calculations rather than giving useful information to investors. So, when IFRS is adopted for consolidated statements for the latter purpose, national rules are still needed for unconsolidated statements for the former purpose.

Circumstantial evidence in favour of the above is that Australia and Canada have not maintained national rules alongside IFRS (even for unconsolidated statements), whereas France and Germany have. A larger case study, of 17 European countries, is given below.

It is worth adding a coda to this discussion. The reason for a brake on the adoption of IFRS for unconsolidated statements or unlisted companies in Class A countries is that the investor purpose is not so obvious for such reporting; a related point is that IFRS might demand too many costly disclosures for that reporting. The solution is for such countries to adopt *IFRS for SMEs* (IASB 2009) for some purposes. This is being done in South Africa and (approximately) in the UK, for example, and helps to bring about the demise of national rules predicted above.

A case study

We can now use 17 European countries (most[14] of the EU before expansion to include former Communist countries, plus Norway) to test the above proposition. Table 3.1 put those countries into two groups by style of pre-IFRS accounting: Classes A and B. The prediction is that Class A countries will require or allow IFRS for unconsolidated statements, and Class B countries will not. The facts are available on an EU website (European Commission 2010). They are expressed in reverse in Table 4.3; that is, whether national rules continue to be required for unconsolidated statements.

Table 4.3: Whether European countries mandate national rules for unconsolidated accounting

Not required	Required
Cyprus	Austria
Denmark	Belgium
Ireland	France
Italy	Germany*
Luxembourg	Portugal**
Malta	Spain
Netherlands	Sweden
Norway	Switzerland
UK	

* Required for tax and distribution accounting but, for large companies, not for publication.

** Except companies included in an IFRS consolidation.

Source: European Commission (2010).

Inspection reveals a strong association between the left-hand sides of Tables 3.1 and 4.3. To be more formal, we can set up a null hypothesis:

> H_{01} The classification of countries in Table 4.3 is only associated by chance with the classification in Table 3.1.

A chi-square test enables one to reject the null hypothesis at more than 99% significance. So, the proposition at the start of this section can be accepted. Indeed, the only countries that are not correctly classified by using Table 3.1 are Italy and Luxembourg. One explanation as to why Italy granted permission to use IFRS is that Italy likes to be seen to be modern and international and that, in practice, companies will not volunteer to use IFRS for their unconsolidated statements because they would then have to produce a different set for tax purposes. Nevertheless, in principle tax and financial reporting can now be separate in Italy, which is a major legal change. Luxembourg has a long history of extending to companies any choices that are available within EU rules.

14. This excludes Finland and Greece, for which the position on IFRS is complicated because some types of company are allowed to use IFRS for unconsolidated statements.

4.5 IFRS ADOPTIONS OF THE FUTURE

Several important countries have not yet adopted IFRS. Some of these are considered now.

The United States has accepted IFRS statements from foreign registrants since 2007. In a consultation of 2008, the Securities and Exchange Commission (SEC) proposes to require IFRS from US registrants, starting with the largest companies from 2014. At the time of writing, it is unclear whether this proposal will be carried through but the general trend is in that direction.

An important question about the US is which implementation method (of those in section 4.2) might be chosen. The SEC currently uses the first approach (adopting the process) for US GAAP. That is, the SEC requires the use of the standards produced by the Financial Accounting Standards Board. It could take the analogous approach to the IASB. The SEC's writ runs only for listed companies, and it requires consolidated statements only. Section 4.6 notes how the IASB might be relevant in the US beyond that.

In Japan, convergence with IFRS has been proceeding slowly for at least a decade. At the end of 2009, it was announced that certain Japanese listed companies could choose to use IFRS instead of Japanese GAAP for periods ending 31 March 2010. The present option of using US GAAP is removed from 2016. In 2012, a decision is to be taken about whether to require IFRS from 2016.

Of the 'BRIC' countries, China was included in section 4.2. Brazil and Russia are shown by the IASB (2010) as 'require or permit IFRSs'. In Brazil, IFRS is required from 2010 for listed companies and any other financial institutions. In Russia, the picture is much less clear; for many years, a law has been under consideration that would require the use of IFRS for consolidated statements. It has not, so far, been approved by the Duma (by the time of writing, in the middle of 2011). The *IAS Plus* website (Deloitte 2011) shows Russia as 'IFRSs not permitted'. It seems unlikely that Russia will successfully adopt IFRS in the near future.

India is requiring the use of 'notified Indian standards that have been converged with IFRS' for large listed (and some other large) companies from 2011. This will be extended to all listed companies by 2014.

4.6 IFRS FOR SMEs

Although this report is largely concerned with full-scale adoption of IFRS, it is important to note the arrival in 2009 of the IASB's IFRS for SMEs. In terms of the number of entities applying it, this document will no doubt far exceed the reach of IFRS.

IFRS for SMEs has already been adopted (unchanged) in South Africa. The UK's Accounting Standards Board has proposed it as the basis of a new regime to replace UK GAAP from 2014. It could also be used for unlisted companies in the US, where there are at present no reporting requirements for such companies.

The issue discussed in section 4.2 (the variety of implementation methods) is also relevant to SME-IFRS. For example, SME-IFRS could be adopted by fiat or inserted into law or adapted into law. Also, using the arguments of section 4.4, we can predict that IFRS for SMEs will have greater application in Class A countries than in Class B countries.

5. Different national patterns of IFRS practice

5.1 INTRODUCTION

Up to now, we have been looking at how countries can implement IFRS differently into their regulatory systems. For the next four chapters of this report, we turn to a different aspect of IFRS: do the IFRS practices of companies differ along national lines? That is, assuming that IFRS has been implemented in a series of countries, do companies use IFRS differently in different countries? This chapter investigates whether there might be motives for the existence of such national patterns of IFRS practice, and then whether IFRS contains opportunities for such motives to be exercised. Chapter 6 examines whether the motives and opportunities actually led to observable national patterns on the transition to IFRS in some major countries in 2005/6. Chapter 7 looks at whether any national patterns have survived after several years of IFRS practice. Chapter 8 asks if the groupings of countries in Chapter 3 are relevant for this new type of international difference. For example, are Australian and UK IFRS practices similar, at least compared with French or Spanish IFRS practices?

5.2 MOTIVES FOR NATIONAL PATTERNS OF IFRS PRACTICE

The obvious place to start looking for motives for different national patterns of IFRS practice is in the literature about why pre-IFRS national accounting systems were different. That was summarised in Chapter 2 of this report, which particularly focused on financing systems, legal systems and tax systems. We can ask now whether these factors might be relevant for IFRS practice. Let us take Germany and the UK as examples of different approaches to accounting, as suggested by the classifications in Chapter 3.

In Chapter 2, Germany was seen to have a weak equity market compared with the UK or the US. There have been changes over time, but the contrast is still clear. If many German listed companies are still dominated by 'insider' finance, that might still affect their attitudes to accounting, eg they might see no need to try to over-state earnings or to make some types of disclosure.

Legal systems were also divided into two types in Chapter 2: Roman codified law and common law. This is still potentially relevant because financial reporting, even 'international' reporting, is carried out under national laws. Also, the quality of financial reporting is monitored and enforced by national agencies. Some national laws tinker with IFRS, and some national agencies do a better job of monitoring and enforcement than others.

The greater dominance of tax over financial reporting under German (compared with the UK's) domestic rules was also noted in Chapter 2. At first sight, this should not affect the consolidated IFRS reporting of German groups of companies. Nonetheless, tax-driven choices in German unconsolidated statements might flow through to IFRS consolidated statements. For example, suppose that German companies under German GAAP tend to choose weighted average cost (AVCO) for inventory valuation because tax law restricts the use of LIFO and FIFO.[15] It would then be likely that AVCO will flow through to the IFRS consolidated statements, given that it is acceptable under IAS 2.

In addition to company motivations, there might be government motivations. In some cases, the latter might reflect the former. For example, in late 2008, the French government publicly demanded that an option should be added into IAS 39 to allow reclassification of financial assets out of 'trading'. This presumably reflected the desire of French financial institutions, among others. By contrast, the Spanish central bank's interpretation of IAS 39 on the impairment of receivables relates to the prudential regulation of banks.

5.3 OPPORTUNITIES FOR NATIONAL PATTERNS OF IFRS PRACTICE

There are many opportunities for different IFRS practice among companies, including:

- different versions of IFRS (eg Australia and the EU as discussed in section 4.2)
- different translations of IFRS
- transitional issues
- imperfect enforcement
- gaps in IFRS
- overt options in IFRS (eg FIFO and weighted average in IAS 2)
- covert options in IFRS
- estimations in IFRS.

These will now be examined in turn. The first four are related to a company's jurisdiction. The other four involve choices and estimations, which could tend to be made differently depending on the company's jurisdiction.

15. Last in, first out (LIFO) and first in, first out (FIFO).

Different versions of IFRS
As explained in section 4.2, EU-endorsed IFRS contains more flexibility on hedge accounting than does the IASB's IAS 39. As another example noted earlier, the Venezuelan version of IFRS does not contain the dozens of amendments to IFRS of the last six years. So, there are different versions of IFRS in different countries, and therefore different practices can result.

Different translations of IFRS
It is essential for IFRS to be translated into several languages. There are, for example, two official IASB translations into French (one EU and one Canadian). Often, meanings can be lost in translation. Sometimes, there are clear errors, of which three examples can be given.

- Cash flow statements are required by IAS 7, reconciling to 'cash and cash equivalents'. The term 'cash equivalents' is defined in paragraphs 6 to 9 of IAS 7, including: 'An investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months…'. This is an attempt to avoid writing a rule, as opposed to establishing a principle. The Portuguese translation of IAS 7 omits the word 'say'. This makes the standard easier to use, but does not translate it accurately. As a result, it will be more difficult in Portugal than in Spain to argue successfully that an investment with a maturity of just over three months is a cash equivalent.

- IAS 41 (para. 34) requires that an unconditional government grant related to a biological asset be recognised as income when the grant becomes 'receivable'. The Norwegian version translates this as *mottas*, which means 'received'. A grant could be receivable many years before it is received.

- The German translation[16] of IAS 19 requires the discount rate for pension liabilities to be set by reference to *Industrieanleihen* (industrial bonds), whereas the original refers to corporate bonds (para. 78), which is a wider category.

Such problems could lead to differences in IFRS practice.

Transitional issues
On transition to IFRS, companies are allowed (by IFRS 1) to retain several figures from their previous balance sheets. For example, most UK companies had the following goodwill treatment in 2003 under UK GAAP:

- goodwill arising before 1998 was written off against reserves on acquisition, and

- goodwill purchased after 1998 was being amortised over 20 years.

The resulting meaningless total became the opening balance of goodwill on 1 January 2004 for transition to IFRS (for a company with a 31 December year end). Companies from other countries had various opening figures that were also meaningless for different reasons. These country-based IFRS differences will survive for many years.

Imperfect enforcement
As noted briefly in section 5.2, monitoring and enforcement of IFRS remains a national matter. In some countries, there are powerful governmental regulators, at least for listed companies. An example is the Autorité des Marchés Financiers in France. In other countries, there is a private-sector body, such as the UK's Financial Reporting Review Panel (FRRP), which can take companies to court for defective accounting. In countries that have no effective regulator, audited financial statements that assert compliance with IFRS might not in fact comply.

Gaps in IFRS
We now turn to four more opportunities for companies to adopt different IFRS practice. These are not intrinsically national like those above but they could lead to national biases in the choices made by companies.

The first of these is gaps in IFRS. The most obvious gaps relate to accounting for insurance contracts and for mineral extraction (including oil and gas). Although these topics are addressed by IFRS 4 and IFRS 6, respectively, those standards place few constraints on companies. The result is that, generally, pre-IFRS practice continues. So, Australian insurance companies continue with Australian practices, and Spanish companies with Spanish practices.

Overt options for IFRS
Throughout the nearly 30-year life of the International Accounting Standards Committee (IASC), standards needed a 75% majority of votes in order to be passed by its Board. One result was the inclusion of many national options. The IASC started to remove these, notably in an 'improvements' project completed in 1993. The IASB has been removing more options, though creating a few new ones.[17]

Table 5.1 lists all the options available[18] in 2010. The motives discussed in section 5.2 might lead companies to make choices among these along national lines. For example, German law requires investment properties to be measured at cost (or lower), whereas UK GAAP (SSAP 19) requires them to be measured at a current market value. IAS 40 (para. 30) allows companies an enterprise-wide choice of cost or fair value. We can guess, then, that when moving from national practice to IFRS, German companies would continue with cost whereas UK companies would choose fair value. Whether such guesses turn out to be correct is investigated in Chapters 6 and 7.

16. This refers to the EU translation and (until 2011) the IASB's translation. In 2011, the IASB's translation was corrected.

17. For example, there is a choice for the calculation of goodwill in the context of non-controlling interests (IFRS 3, para. 19, issued in 2008).

18. According to the author's analysis.

Table 5.1: Examples of overt options in IFRS, 2010

IAS 1	No format requirements for statements of financial position or comprehensive income (paras 79 and 82).
IAS 2	Either FIFO or weighted average for the determination of the cost of inventories (para. 25).
IAS 2	Marking to market allowed for inventories of commodity broker-traders (para. 3).
IAS 7	Net basis allowed for cash flow statements (para. 21).
IAS 7	Choice of classification for interest and dividend flows (para. 31).
IAS 16	Either cost or fair value measurement basis for classes of property, plant and equipment (para. 29).
IAS 19	Actuarial gains and losses can be taken (a) immediately in full to the statement of recognised income and expense (SORIE), (b) immediately in full to the income statement, (c) in full to income over the remaining useful lives of employees in the plan, (d) in full to income over a shorter period (paras 92–93A).
IAS 20	Asset grants can be shown either as a deduction from the asset or as deferred income (para. 24).
IAS 27	In parent statements, subsidiaries can be shown either at cost or as available-for-sale investments (para. 37).
IAS 28	In investor statements, associates can be shown either at cost or as available-for-sale investments (para. 38).
IAS 31	In group statements, there is a choice of either proportional consolidation or equity accounting for joint venture entities (para. 30).
IAS 31	In venturer statements, joint ventures can be shown either at cost or as available-for-sale investments (para. 46).
IAS 38	Either cost or fair value measurement for some types of intangible asset (para. 72).
IAS 39	Choice of either cost basis or marking to market for some financial assets and liabilities (para. 9). (Other choices are also available within para. 9.)
IAS 40	Permission to classify a property held under an operating lease as an investment property (para. 6).
IAS 40	Entity-wide choice of either cost or fair value as the measurement basis for investment property (para. 30).
IFRS 3	Choice on the calculation of goodwill in the context of non-controlling interests (para. 19).

Covert options in IFRS

There are many cases of vague criteria that can lead to different interpretations. Each year, there are large numbers of queries to the IFRS Interpretations Committee on issues about which companies or auditors think that IFRS is unclear. Some of these lead to official interpretations or amendments of IFRS. This process is a symptom of the complexities of business, accounting and the content of IFRS. There are still many issues where different interpretations are plausible (and which are, in effect, covert options), and where IFRS practice might follow national traditions.

A long-standing example of the need to interpret criteria is the requirement in IAS 11 (and in many national GAAPs) to use the percentage-of-completion method **if the outcome of the contract can be estimated reliably**. Varying degrees of conservatism in the accounting cultures of different countries might lead to different conclusions about the same contract. Table 5.2 gives examples of covert options in IFRS, most of which involve probability estimates or assessments of some other kind of percentage.

Estimations in IFRS

Any interesting accounting topic requires estimations as part of the measurement of items. Table 5.3 gives examples in the context of IFRS. Taking the topic of impairment, it is first necessary to judge whether an impairment test is needed (a covert option) and then, if it is, to estimate cash flows and discount rates. These estimations might, again, be affected by national accounting culture. There is also scope for a tax effect. In a country where impairments are tax deductible, there will be a tendency to find them and to estimate them to be large in unconsolidated statements under national GAAP. These figures might flow through to IFRS consolidated statements.

Table 5.2: Examples of covert options or vague criteria in IFRS, 2010

IAS 1	Determination of whether a liability is current on the basis of the expected date of settlement or purpose of holding (para. 60).
IAS 8	The determination of materiality for various purposes (para. 5).
IAS 11	Use of percentage of completion method only if the outcome of a contract can be estimated reliably (para. 22).
IAS 12	Recognition of a deferred tax asset for a loss carry forward only if future taxable profit is probable (para. 34).
IAS 12	Recognition of a deferred tax liability on unremitted profits from subsidiaries only if dividends are probable in the foreseeable future (para. 39).
IAS 17	Lease classification based on 'substantially all the risks and rewards' with no numerical criteria (para. 8).
IAS 21	Determination of functional currency based on a mixture of criteria (paras 9–12).
IAS 23	Cessation of capitalisation of borrowing costs when 'substantially all' the activities to prepare the asset are complete (para. 22).
IAS 27	Identification of a subsidiary on the basis of 'power to control' (para. 4).
IAS 28	Identification of an associate on the basis of 'significant influence' (para. 2).
IAS 31	Identification of a joint venture on the basis of joint control of 'strategic financial and operating decisions' (para. 3).
IAS 36	Identification of an indication of impairment based on a mixture of criteria (paras. 12–14).
IAS 37	Recognition of a provision based on probability of outflow of resources (para. 14).
IAS 38	Capitalisation of development costs when all criteria are met (para. 57).
IAS 38	Amortisation of intangible assets only if useful life is assessed as finite (para. 88).
IAS 39	Use of cost basis where equity instruments cannot be measured reliably (para. 46).
IAS 39	Estimation of hedge effectiveness as a condition for use of hedge accounting (para. 88).
IAS 40	Use of cost basis, despite entity-wide choice of fair value, for an investment property whose fair value cannot be measured reliably (para. 53).
IAS 41	Use of cost basis for a biological asset whose fair value cannot be measured reliably (para. 30).
IFRS 3	Identifying the acquirer in a business combination presented as a merger of equals (para. 20).
IFRS 5	Treatment of assets as held-for-sale if expected to be sold within one year (para. 8).
IFRS 8	The determination of reportable segments based on a mixture of factors (para. 11).

Table 5.3: Examples of measurement estimations in IFRS, 2010

IAS 2	Net realisable value of inventories (paras. 30, 31).
IAS 11	Costs attributable to a contract (para. 16).
IAS 12	Tax rate for deferred tax calculations based on the expected manner of settlement or recovery (para. 51).
IAS 16 (and IASs 17, 38, 40)	Depreciation (or amortisation) based on estimates of useful life, residual value, and pattern of consumption (paras 50, 51 and 60).
IAS 16 (and IASs 38, 40)	Fair value when selected as a measurement basis (paras. 31–34).
IAS 19	Pension obligations based on estimates of mortality, final salary, etc (para. 64).
IAS 36	Discounted cash flows or net realisable values for impairments (para. 18).
IAS 37	Best estimate of provisions based on percentage likelihoods of outflows (para. 40).
IAS 39	Fair values of certain financial assets and liabilities (para. 48).
IAS 41	Fair values of biological assets (para. 12).
IFRS 2	Fair value of equity instruments (eg share options or shares in an unlisted company) granted to employees (para. 11).
IFRS 3	Allocation of cost of a business combination to assets and liabilities of acquiree based on fair values (para. 36).

6. National patterns on transition to IFRS

6.1 CHOOSING COUNTRIES AND COMPANIES TO STUDY

The next two chapters seek to discover whether the motives and opportunities for different national patterns of IFRS practice (as examined in Chapter 5) have actually led to such patterns. This chapter examines the earliest year for which there were IFRS reports from companies on several major stock markets. As explained in Chapter 4, IFRS practice has not yet arrived in mainland China, Japan or the US. Of the world's 10 largest stock markets, only Germany required the use of IFRS before 2005 but several other major countries introduced requirements for 2005 onwards. Therefore, this chapter, examines IFRS practice for accounting years beginning on or after 1 January 2005.

The countries chosen were those with the world's five largest stock markets in 2005 that required use of IFRS for the consolidated statements of listed companies (according to data from the World Federation of Stock Exchanges, June 2005). The countries are Australia, France, Germany, Spain and the UK. This list includes countries from both classes A and B in Chapter 3.

Large listed companies were chosen from these five countries for two reasons. First, their annual reports (in English) are easy to obtain. Secondly, any findings are likely to be generalisable. That is, the largest companies are likely to be the most international and the least likely to exhibit country-specific practices. Therefore, even if they exhibit such practices, it is likely that most companies in that country do.

We take the companies that compose the main stock market indices: ASX 50, CAC 40, DAX 30, IBEX 35 and FTSE 100. Germany was a special case for two reasons: (1) many companies had adopted IFRS earlier, and (2) seven of the DAX 30 were still using US GAAP, as allowed for 2005 and 2006 by German law. For the study of the most recent reports (see Chapter 7), however, all the DAX companies can be included. Excluding companies using US GAAP and a few foreign companies (eg a Belgian company in the CAC 40 index), this led to a sample of 232 IFRS reports.

6.2 HYPOTHESIS OF COMPANY BEHAVIOUR ON TRANSITION

Although the main purpose of this chapter is to discover whether national patterns of IFRS practice exist, it will be useful to go further by explaining why a particular pattern is found in a particular country. For this, a hypothesis is helpful:

> When a company uses IFRS for the first time, it will tend to continue its previous accounting policies wherever possible.

There are several reasons for expecting this behaviour (apart from inertia).

- It continues to fulfil whatever incentive led to the policy choice in the first place.
- It reduces the costs of data handling, training and audit.
- It assists users of financial statements by maximising continuity.

In order to predict which accounting policies a company will choose under IFRS, it is necessary to create a list of topics that allow choices and then to discover which choice the company made under pre-IFRS national rules. For many topics, a company had no choice under pre-IFRS national rules, so it is not necessary to look at all policies for all companies individually.

Table 6.1 contains a list of policy choices, drawn from the list of overt options in Table 5.1. Policy choices that do not affect consolidated statements are omitted. Table 6.1 also contains a record of which practice was required by pre-IFRS national rules. In a few cases, the predominant practice of large companies is recorded instead. The information for all this comes from a variety of reference works.[19]

19. Australian and UK accounting standards; German Commercial Code (HGB); French and Spanish accounting plans; Ordelheide and KPMG (2001).

Table 6.1: IFRS policy choices and pre-IFRS practices

		IFRS Option	Aus	UK	Ger	Fra	Spa
1*	(a)	Balance sheet shows assets = credits	–	–	R	R	R
	(b)	Balance sheet shows net assets	R	P	–	–	–
2*	(a)	Balance sheet liquidity increasing	–	R	R	R	R
	(b)	Liquidity decreasing (starts with cash)	R	–	–	–	–
3*	(a)	Income statement by function	–	–	–	–	–
	(b)	Income statement by nature	–	–	–	–	R
4*	(a)	Equity accounted results included in 'operating profit'	–	–	–	–	–
	(b)	Immediately below 'operating profit'	–	R	R	–	–
	(c)	Below finance	–	–	–	R	R
5	(a)	Statement of changes in equity (SCE)	–	–	–	–	–
	(b)	SORIE, excluding owner transactions	–	R	–	–	–
6*	(a)	Direct operating cash flows	R	–	–	–	–
	(b)	Indirect operating cash flows	–	–	–	–	–
7*	(a)	Interest paid as operating cash flow	R	–	–	R	–
	(b)	As financing	–	R	–	–	–
8	(a)	Only cost for property, plant and equipment (PPE)	–	–	R	R	R
	(b)	Some PPE at fair value	–	–	–	–	–
9	(a)	Investment property at cost	–	–	R	R	R
	(b)	Investment property at fair value	–	R	–	–	–
10	(a)	Capitalisation of interest on construction	R	–	–	–	P
	(b)	Expensing	–	–	–	–	–
11*	(a)	FIFO for inventory cost	–	P	–	–	–
	(b)	Weighted average only	–	–	P	–	–
12	(a)	Actuarial gains/losses to SORIE	–	R	–	–	–
	(b)	To income in full	–	–	–	–	–
	(c)	Corridor	–	–	P	–	–
13	(a)	Proportional consolidation of JVs	–	–	–	R	R
	(b)	Only equity method	R	R	–	–	–

* = Non-financial companies only
R = Required
P = Predominant

6.3 WHICH IFRS POLICIES DID COMPANIES CHOOSE?

The next stage was to obtain the annual reports of the 232 companies for 2005/6 and to discover their choices for the 13 policy issues listed in Table 6.1. It was necessary to hand-pick the data for this, because no convenient database exists. The results of this research are shown in Table 6.2.

Some statistical tests are reported below, but inspection of Table 6.2 immediately reveals major differences between countries. This is most obvious for policy choices 1, 2, 6, 9 and 13. Some countries have no examples of a certain practice, whereas it is the majority choice in others.

A chi-square test can be used to measure whether a policy choice is independent of country. For 12 of the 13 policy choices a null hypothesis of equal practice across countries can be rejected at the 1% level. For the remaining policy choice (8, measurement of PPE), it can be rejected at the 5% level. This is very strong evidence of the existence of national patterns of IFRS practice.

Furthermore, in nearly all cases where a practice was required or predominant before IFRS (shown as 'R' or 'P' in Table 6.1), it is the predominant choice under IFRS (shown by high percentages in Table 6.2). This can be confirmed by binomial tests, for issues that have two choices, using conventional methods of approximations to the normal distribution. For example, on option 1, Australia and the UK are expected to show net assets, whereas the other countries are not. So, Australia can be compared with France, then Spain, then Germany; and then the UK can be compared with France, then Spain, then Germany. This makes six testable hypotheses. All of them enable the rejection of a hypothesis of equality of practice at the 1% level. A large number[20] of such tests provides very strong statistical evidence that IFRS choices can be predicted by pre-IFRS national practices.

Table 6.2 Policy choices (percentages of companies by country), 2005/6

		Aus	UK	Ger	Fra	Spa
1 (b)	Balance sheet shows net assets	100	85	0	0	0
2 (a)	Balance sheet liquidity increasing	0	100	85	100	96
3 (a)	Income statement by function	59	47	76	55	4
3 (b)	Income statement by nature	30	14	24	45	96
3 (c)	Neither	11	39	0	0	0
4 (a)	Equity accounting results included in 'operating profit'	63	25	19	7	0
4 (b)	Immediately below 'operating profit'	16	32	62	3	8
4 (c)	Below finance	21	43	19	90	92
5 (b)	SORIE only (not SCE)	66	84	22	6	25
6 (b)	Indirect operating cash flows	0	98	100	100	88
7 (a)	Interest paid as operating cash flow	91	68	62	89	39
8 (b)	Some PPE at fair value	14	12	0	0	0
9 (b)	Investment property at fair value	43	73	0	0	0
10 (a)	Capitalisation of interest on construction	76	48	22	40	94
11 (a)	FIFO for inventory cost	27	50	0	12	6
11 (b)	Weighted average only	59	29	71	58	88
12 (a)	Actuarial gains/losses to SORIE	73	85	48	20	13
12 (b)	To income in full	18	3	0	6	37
12 (c)	Corridor	9	12	52	74	50
13 (a)	Proportional consolidation of JVs	5	22	31	81	85

20. 68 such binomial tests were carried out: 56 led to rejection at 1%, 10 to rejection at 5%, and 2 to no rejection.

6.4 WHAT ARE THE NATIONAL PATTERNS?

The predictions based on pre-IFRS practices of Table 6.1, slightly corrected by the findings of real IFRS practices as reported in Table 6.2, can be used to record the typical IFRS practices of a particular country. Table 6.3 does that for the five countries examined in this chapter. In that table, 'Y' means 'yes', and is recorded where the score in Table 6.2 is over 70%; 'N' means 'no' and is recorded where the score is under 30%. In a few cases, Y* or N* are recorded where the 70/30 thresholds are narrowly missed. A question mark ('?') is recorded in those few cases where no typical IFRS can be predicted.

6.5 HOW IMPORTANT ARE THE DIFFERENCES IN PATTERNS?

So far, this chapter has examined 13 IFRS policy options (see Table 6.1). The choices made by companies are easy to observe. The options can be divided into three types.

A. Those that are unlikely to hamper international comparisons, eg balance sheet formats (options 1 and 2).

B. Those that can be adjusted for by alert analysts, eg the position of interest paid in the cash flow statement (option 7) or whether actuarial losses are included in the calculation of earnings (option 12).

C. Those that cannot be adjusted for, eg from a by-nature income statement to a by-function one (option 3) or from equity accounting to proportional consolidation (option 13).

An indication of the importance of the difference in patterns can be gained by looking at the two options mentioned in type B: interest paid and actuarial losses. For each, we have selected a country with diverse practices: the UK for interest paid (see 7a in Table 6.2), and Germany for actuarial losses (see 12a in Table 6.2).

Interest paid (UK)

The cash flow statements of 24 UK non-financial companies (33% of the sample) treat interest paid as a 'financing' cash outflow. For these companies, Table 6.4 shows the amount of interest paid and the size of operating cash flows. The '%' column shows how much smaller the operating cash flow would have been if each company had adopted the majority practice of treating interest paid as 'operating'. As may be seen, in one case (Cable and Wireless), this would have caused operating cash flow to be negative. The average of the percentages in Table 6.4 is 20.3%. By contrast, the average for the majority of companies (that show interest paid as operating) was 15.6%. This difference is statistically significant at the 1% level. It suggests that management choice of accounting policy is affected by a desire to improve the look of operating cash flows.

Table 6.3 National patterns of IFRS practice, 2005/6

		Aus	UK	Ger	Fra	Spa
1	Balance sheet shows net assets	Y	Y	N	N	N
2	Balance sheet starts with cash	Y	N	N	N	N
3	Income statement by function	Y*	?	Y	?	N
4	Equity accounting profits included in 'operating profit'	Y*	N*	N	N	N
5	SORIE only (not SCE)	Y*	Y	N	N	N
6	Indirect cash flows	N	Y	Y	Y	Y
7	Interest paid as operating cash flow	Y	Y*	Y*	Y	N*
8	Only cost for PPE	Y	Y	Y	Y	Y
9	Investment property at cost	?	N	Y	Y	Y
10	Capitalisation of interest on construction	Y	?	N	?	Y
11	Weighted average only for inventory	?	N*	Y	?	Y
12	Actuarial gains/losses to SORIE	Y	Y	?	N	N
13	Proportional consolidation of JVs	N	N	?	Y	Y

Table 6.4: Interest paid and operating cash flows for UK non-financial companies 2005/6 that show interest paid as 'financing' (£m)

	Interest paid £m	Operating cash flow £m	%
AngloAmerican	547	6781	8.1
Antofagasta	23.3	1304.7	17.9
Associated British Foods	47	419	11.2
BAT	371	2324	16.0
BG	72	1606	4.5
BSkyB	105	875	12.0
BT	1086	5387	20.2
Cable & Wireless	61	56	108.9
Daily Mail	50.1	350.8	14.3
DSGI	20.5	3367	6.1
Enterprise Inns	234	465	50.3
Gallaher	163	572	28.5
Glaxo	381	5958	6.4
Imperial Tobacco	199	1155	17.2
Johnson Matthey	30.6	212.3	14.4
Kingfisher	39.3	304.1	12.9
M&S	142.8	1096.0	13.0
National Grid	834	2971	28.1
Next	21.4	398.2	5.4
Punch Taverns	319.1	535.1	59.6
Rolls Royce	88	1060	8.3
Royal Dutch Shell	1124	30113	3.7
Unilever	643	4353	14.8
Vodafone	1254	20595	6.1
Average of the percentages			20.3

Actuarial losses (Germany)

A majority of German non-financial companies (71%) took actuarial gains and losses (AGL) to the SORIE. The SORIE was the statement that contained what is now called 'other comprehensive income'. In all but one case, the AGL was a loss (see Table 6.5). Adopting the SORIE treatment protects the income statement from losses but increases the pension liability. It is somewhat complex to work out the percentage effects because it involves calculating what would be the size of the corridor and the length of amortisation. However, an academic study of German companies (Stadler 2010) shows strong evidence that the SORIE treatment is chosen by companies that would have AGL in excess of the corridor.

It is easy to give an indication of how important this policy choice is. Table 6.5 shows the size of actuarial gains and losses as a proportion of the profit (pre-tax, in each case). As may be seen, pre-tax profit would have been greatly reduced for many companies if AGL had been charged to income. Use of the corridor would have reduced the effect.

Table 6.5: Actuarial gains/losses of German companies presenting a SORIE, 2005 (€m)

Company	Actuarial gain (loss) (€m)	Pre-tax profit (€m)	%
Adidas	(9)	655	(13.7)
BASF	(1075.9)	5925.6	(18.2)
Bayer	(1207)	2199	(54.9)
BMW	(736)	3287	(22.4)
Henkel	(72)	1042	(6.9)
Linde	(73)	789	(9.3)
Merck	(113.6)	893.4	(12.7)
Thyssen	385*	2623	14.7
Tui	(297.6)	385.5	(77.2)
Volkswagen	(1231)	1722	(71.5)

* loss of 760 in previous year.

6.6 MORE COMPLEX IFRS PRACTICES

The evidence concerning national patterns (discussed in sections 6.3 to 6.5) is important even for options referred to as type A in section 6.5 (ie those unlikely to hamper international comparisons) because it bolsters the following proposition:

> Given the strong evidence for national patterns of IFRS practice from accounting policy choices which are easily observed, we can expect national patterns of practice on topics that cannot easily be observed.

The following are among the important topics for which national patterns are likely but are difficult to uncover.

Impairment indicators
Under IAS 36, impairment testing is only necessary, for most assets, if there are indications of a possible impairment. Identifying these indications requires judgement. Accountants in some countries might be more than averagely prudent in this identification, for example, because of a long history of conservatism or the tax-deductibility of impairments under national rules.

Impairment measurements
IAS 36 requires the measurement of discounted cash flows or fair value or both. For damaged, used assets this involves considerable judgement (in estimating cash flows, choosing discount rates, etc). As above, the degree of prudence might differ internationally.

Recognising development assets
IAS 38 requires development costs to be capitalised rather than expensed when a series of criteria are met. This leaves scope for different national traditions to continue.

Contract accounting
Under IAS 11, the percentage-of-completion method should be used when the outcome of a contract can be reliably estimated. Again, different national traditions of prudence could lead to different interpretations of this.

Deferred tax assets
Under IAS 12, deferred tax assets should be recognised when they are more likely than not to be recovered. In some national traditions, however, deferred tax assets do not exist (because there are no timing/temporary differences) or are only recognised when virtually certain, or highly probable, etc. This tradition could affect the behaviour of accountants under IFRS.

Scope of consolidation
Under IAS 27, group A should consolidate entity B if B is controlled. This can sometimes occur if A holds less than half the voting rights or even no shares at all. Accountants from some national traditions might tend, in practice, to base identification of control on reliable criteria such as shareholdings. The same applies to the identification of significant influence under IAS 28.

7. Have national patterns persisted?

7.1 INTRODUCTION

Chapter 6 has shown that national patterns of IFRS practice existed in five important capital markets in 2005/6. Nevertheless, that was a transition year for most of the 232 companies surveyed. It is possible that, faced with the major task of transition, companies took the easiest route by maintaining their previous policies wherever possible. In subsequent calmer times, however, they might have learnt to exploit the options available in IFRS. Although IAS 8 attempts to restrict changes to accounting policy, it will often be possible to make changes on the grounds of better accounting or altered circumstances.

This chapter investigates to what extent changes to policies were made in the first three years after transition, and whether national patterns of IFRS practice can still be discerned.

7.2 POLICY CHANGES FROM 2005/6 TO 2008/9

In order to examine IFRS policy changes from 2005/6 to 2008/9, the same companies are considered as in Chapter 6, except that of these, 22 no longer presented IFRS consolidated statements in 2008/9 (largely because of takeovers). The resulting sample is 210 companies. The same 13 policy choices are used as in Chapter 6, all of which were still available in 2008/9.

For a few of the options, the IASB had announced amendments by the time the 2008/9 statements were prepared.

- IAS 1 had been amended in 2007 for compulsory adoption in 2009/10. This affects option 5 of the tables in Chapter 6: an entity is now required to present (i) other comprehensive income either as a separate statement (like a SORIE) or as part of a comprehensive income statement; and (ii) a statement of changes in equity.
- IAS 23 had been amended in 2007 for compulsory adoption in 2009/10. This affects option 10: the option of expensing interest is removed.
- ED 9 was issued in 2007, proposing to remove IAS 31's option of proportional consolidation. This would affect option 13, although no Standard had been issued by the end of 2009.

In this section these three options are considered separately from the others.

Table 7.1 shows the average number of policy changes per company from 2005/6 to 2008/9. As may be seen, the changes are few, especially for Australia and the UK. When the changes related to amendments to IASs 1, 23 and 31 are excluded there are very few changes indeed. For example (not shown in Table 7.1), there were no policy changes for the great majority of Australian and UK companies: 83% and 85%, respectively. The noticeable difference in the number of policy changes between the 'Anglo' companies (Australia and the UK) and the Continental European companies is examined in Chapter 8, along with other differences between these two groups.

Table 7.1: Policy changes per non-financial company

Country	Average number of policy changes
Australia	0.30
UK	0.34
Germany	0.65
France	1.03
Spain	1.25

7.3 ONE MAJOR POLICY CHANGE

Of the policy changes that were not related to early adoption of amendments to IFRS, a majority were on one topic: the treatment of actuarial gains and losses (AGL). In IAS 19, there are three possible methods for AGL.

A Taking them immediately to the SORIE/other comprehensive income (OCI) (option introduced in 2004).

B Ignoring small AGL, and taking the rest to profit and loss slowly (the corridor approach).

C Taking AGL to profit and loss immediately.

From 2005 to 2010, most companies had actuarial losses rather than gains.[21] Method A above protects the calculation of earnings from those losses (and from volatility, if there are gains). Method B reduces volatility of earnings and protects the balance sheet from big increases in pension obligations. Method C is simplest but causes the most volatility to earnings and liabilities.

21. See, for example, Stadler (2010).

We can now make some predictions based, among other things, on the arguments of Chapter 4.

- 'Anglo' companies (eg Australian and UK) will be especially interested in stock market reactions, and will therefore be averse to volatility, and will use the SORIE.
- UK companies will take the SORIE approach under IAS 19 on transition in 2005/6 because it preserves pre-IFRS UK practice.
- French and Spanish companies are less worried about stock market reactions, and had no SORIE in pre-IFRS practice, so will not use the SORIE.
- German companies will not use the SORIE in 2005 because there was no SORIE option in pre-2004 IFRS practice or in German GAAP.
- Over time, some Continental European companies will learn to use the new (SORIE) option to protect earnings.

Table 7.2 shows the percentages of companies using the SORIE for 2005/6 and 2008/9. As may be seen, all the five above propositions about AGL can be confirmed as follows.

- Nearly all Australian and UK companies use the SORIE.
- Few French and Spanish companies used the SORIE in 2005 (most used the corridor).
- German companies generally did not use the SORIE in 2005 (55% used the corridor).
- Companies that were not using the SORIE in 2005 gradually learnt to use it by 2008.

One further possibly relevant explanation for the use of the corridor is a listing in the US (or other cause of SEC registration), given that the corridor is used in US GAAP. Even so, there is little evidence in favour of this explanation. About one-third of the 23 German companies that used IFRS in both 2005 and 2008 were using the corridor in 2008. These are about equally divided into SEC registrants and non-registrants. Of the seven additional German companies that had used US GAAP in 2005, only two used the corridor under IFRS in 2008.

Table 7.2: Percentages of companies using the SORIE for actuarial gains and losses

Year	% Australia	% UK	% France	% Spain	% Germany
2005	73	83	21	14	45
2008	86	86	50	63	63

7.4 PERSISTENCE OF NATIONAL PATTERNS

Given how few changes of policy there were after 2005/6, the national patterns identified in Chapter 6 could be expected to have persisted. To check this, the chi-square test used in section 6.3 was repeated for the choices on the 13 topics for the 210 companies. The seven German DAX companies that had been using US GAAP in 2005 were included. As before, for all the topics except PPE measurement, a hypothesis of equal practice across the countries can be rejected at the 1% level.

The conclusion is that the national patterns of IFRS practice remain largely the same as in 2005/6 and are still very clear. Table 7.3 updates the national patterns (as shown in Table 6.3 on page 28 for 2005/6) to the practices of 2008/9. The main change is to options 5 and 12, which are related. For these, continental companies have moved to the 'Anglo' practices.

Table 7.3: National patterns of IFRS practice, 2008/9

		Aus	UK	Ger	Fra	Spa
1	Balance sheet shows net assets	Y	Y	N	N	N
2	Starts with cash	Y	N	N	N	N
3	Income statement by function	?	?	Y	Y*	N
4	Equity profits in operating profit	Y*	?	N*	N	N
5	SORIE only	Y*	Y	N	N	N
6	Indirect cash flows	N	Y	Y	Y	Y
7	Interest paid as operating profit	Y	Y*	Y*	Y	?
8	PPE at cost	Y	Y	Y	Y	Y
9	Investment property at cost	?	N	Y	Y	Y
10	Interest capitalisation	Y	?	N	?	Y
11	Weighted average only	?	N*	Y	?	Y
12	AGL to SORIE	Y	Y	Y*	?	Y*
13	Proportional consolidation of JVs	N	N	?	Y	Y

8. Country groups and national patterns of IFRS

8.1 INTRODUCTION

Chapter 3 examined the evidence for the existence of groups of countries that have similar accounting systems. In Chapter 4, these groupings were useful in explaining how different countries reacted with varying degrees of enthusiasm to IFRS.

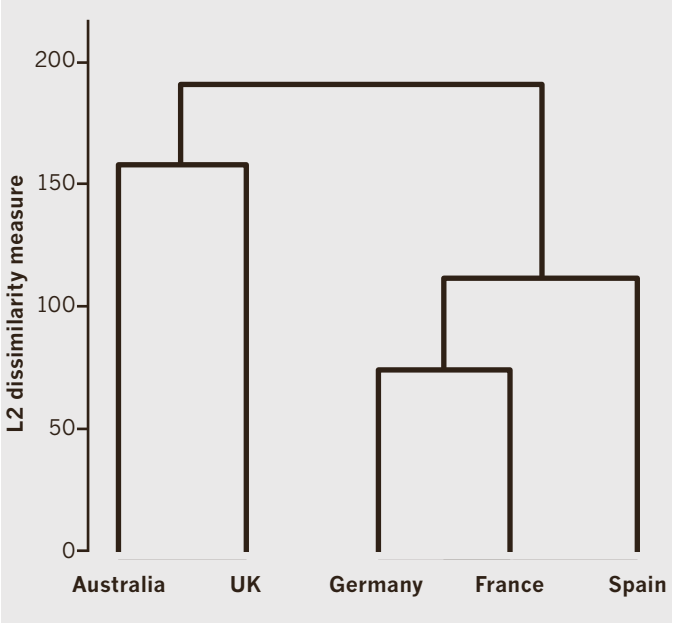
This chapter considers whether national patterns of IFRS fall into similar groups, and whether the frequency of IFRS policy changes is related to this. For this, the data on topics and countries that were collected for Chapters 6 and 7 can be used.

8.2 CLASSIFICATION OF COUNTRIES BY IFRS PRACTICES

Using the data on the IFRS policy choices made by companies in 2005/6 (see Table 6.2), statistical techniques can be used to examine whether the five countries fall into groups. Previous researchers[22] in the field of classification have used principal component analysis, cluster analysis and multidimensional scaling. All these tests have been performed here and they lead to the same conclusion: there is an 'Anglo' group (Australia and UK) and a Continental European group. This is best illustrated by the dendrogram that results from cluster analysis, shown as Figure 8.1.

The conclusion is that the two-group classification of national practices (discussed in Chapters 3 and 4) can still be found in national versions of IFRS practices.

Figure 8.1: Dendrogram showing classification of countries by IFRS practices



22. For example, Frank (1979) and d'Arcy (2001).

8.3 COUNTRY EFFECT ON POLICY CHANGES

As shown in Table 7.1 on page 31, there were clearly more policy changes (from 2005/6 to 2008/9) for Continental European companies than for 'Anglo' companies. This is a statistically significant finding. So, again, a two-group classification can be found for this aspect of accounting. As explained in section 7.3, most of these changes concerned the treatment of actuarial gains and losses and the related presentation of other comprehensive income.

8.4 A MAJOR IMPLICATION

We can now consider a major question behind much of the discussion in this report: are options and flexibility within Standards useful (or perhaps even necessary) for good financial reporting in an international context? We can summarise the arguments for and against having such flexibility.

For
There are major, deep-seated and long-lasting differences between countries. These include culture, legal systems, tax systems, financial systems and language. Therefore, international differences in financial reporting are expected, inevitable and welcome. Options and flexibility in IFRS help companies to adapt to it. Different countries have different ways of doing business, different contract types, different predominant industries, and so on. So, options are necessary.

Against
Whereas international differences in financial reporting might, indeed, be useful for accounting designed for domestic purposes (eg for tax or dividend calculations), for companies that are competing in the same international market for capital, comparable financial reporting is required. For these purposes, therefore, options and flexibility in IFRS are not helpful. If there are two types of transactions/contracts/etc that should have two types of financial reporting, the solution is not to create options and flexibility. A Standard should set out principles for determining which of the two economic conditions is present. It should then require method 1 accounting for type 1 conditions, and method 2 accounting for type 2 conditions. The problem with options and flexibility is that they can be deliberately misused or that national traditions persist for no good economic reason.

This leads to the conclusion that, although international variety is welcome in many other fields (eg cuisine, language), and it is harmless in some others (eg possibly in accounting by private companies), where international comparability is required (eg in IFRS reporting to international investors), variety can be dangerous unless it reflects underlying differences in reality rather than national traditions or preferences. For example, there seems to be no compelling underlying economic reason why only 16% of German companies should proportionally consolidate their joint ventures in 2008/9, whereas 91% of Spanish companies do so. Apart from anything else, this greatly increases the cash and sales figures of the Spanish companies compared with the German companies, rendering the financial statements non-comparable.

There is no obvious reason to justify the continuation of any of the 13 policy choices documented in Chapters 5 to 7.

9. Does size matter?

9. 1 INTRODUCTION

Some of the findings in Chapters 6 and 7 are surprising. For example, the majority of German companies use the by-function income statement, even though this was not allowed in Germany until 1987 (with the revision of the *Handelsgesetzbuch* after the Fourth Directive). Such discoveries raise the question as to whether very large companies might be atypical of their country. This chapter makes a preliminary investigation of this question by examining the 13 accounting options of Chapter 7 for the same period (2008/9) for smaller listed companies.

German companies have been selected here because an inspection of the policies of large companies (eg Table 7.3) suggests that it is the German ones that might be especially affected by international pressures to move away from traditional German practices.

9.2 DATA AND RESULTS

The 25 smallest listed non-financial companies were selected from the list of the Deutsche Börse. This is a similar sample size to that in Chapter 7. Data were then hand-picked for the 13 options of Chapter 7 from the 2008 annual reports (all of which were available in English). The results of the investigation are shown in Table 9.1.

As may be seen in Table 9.1, there are considerable differences between the practices of small and large German companies on several options. As the table shows, three of these differences are highly significant and two are significant at the 5% level. There were limited data on topic 13, so the significance of the large difference could not be confirmed.

The differences can be summarised as showing that smaller companies stay closer than large companies to traditional German practices. In general they:

- use the by-nature income statement
- use a liquidity-increasing balance sheet
- do not present a SORIE
- do not capitalise interest
- do not take actuarial gains/losses to the SORIE.

9.3 IMPLICATIONS

This preliminary study suggests that there are significant differences between the IFRS policies of small and large companies. Further investigation is warranted.

The findings reinforce those of Chapters 6 to 8. That is, small German companies have an even more distinct pattern of policies (eg more removed from the practices of UK companies) than do large German companies. If small companies have even more distinct national profiles than large companies, then the country groupings discovered in Chapter 8 would be even more distinct for smaller companies (ie most companies).

Table 9.1: Policy choices of German non-financial companies 2008 (percentages)

		Large companies	Small companies	Difference
1 (b)	Focusing on net assets	0.0	0.0	0.0
2 (a)	Balance sheet liquidity increasing	69.6	92.0	+22.4**
3 (a)	Income statement by function	82.6	36.0	–46.6***
4 (a)	Equity accounting results included in ‘operating profit’	22.7	15.4	–7.3
5 (b)	SORIE only	43.5	8.0	–35.5***
6 (b)	Indirect operating cash flows	100.0	100.0	0.0
7 (a)	Interest paid as operating cash flow	68.2	76.0	+7.8
8 (b)	Some PPE at fair value	0.0	0.0	0.0
9 (b)	Some investment property at fair value	0.0	0.0	0.0
10 (a)	Capitalisation of interest on construction	43.5	11.1	–32.4**
11 (b)	Weighted average only	75.0	68.4	–6.6
12 (a)	Actuarial gains/losses to SORIE	73.9	25.0	–48.9***
13 (a)	Proportional consolidation of JVs	18.8	42.9	+24.1

*** = 1% level significance
** = 5% level significance

10. Conclusions

10.1 CONCLUSIONS

The first important conclusion of this report relates to identifying the main influences on a country's accounting system. If a country's regulatory and financial culture has been dominated by another country's, then that will explain its accounting system. Otherwise, the main explanatory factor for a country's type of accounting is the financing system and the related mix of corporate owners. If a country changes its financing system, the purpose of accounting (and, therefore, the type of accounting) changes. On the basis of this, accounting systems can initially be divided into two classes, depending on whether or not the country has a large number of outside shareholders. Any one country can use more than one system for different purposes.

For companies that raise money on an international basis, there is a strong argument for comparability of financial reporting, perhaps based on IFRS. There are many ways to implement IFRS in a jurisdiction. Few jurisdictions require companies to comply directly with IFRS as issued by the IASB.

The two-group classification of countries by their accounting systems ('Anglo' compared with Continental European) is useful for predicting and explaining how a jurisdiction will react to IFRS, eg whether IFRS is allowed for unconsolidated reporting.

The motives that led to differences between national financial reporting systems might still drive differences in the way in which IFRS is practised. The most obvious opportunity for these differences to arise is the existence of options in IFRS, but unobservable differences might be even more important. On first-time adoption of IFRS, a company is likely to continue with its previous policies, and this applies to many accounting policies.

An examination of the IFRS policies of large listed companies of five major countries in 2005 provides strong evidence for this hypothesis of continuing national practices. This means that national patterns of IFRS practice do exist and can be described.

A study of the IFRS policies of the same companies in 2008 reveals few policy changes, and therefore indicates the persistence of national patterns. One major change between 2005 and 2008 was the move by Continental European companies to the 'Anglo-Saxon' policy of treating actuarial gains and losses as other comprehensive income (and, therefore, having to present a statement showing such income).

The previously discussed two-group classification of pre-IFRS accounting systems was still statistically apparent when looking at the 2005 policy choices. This classification was also apparent in the amount of policy change over the period from 2005 to 2008, with the Continental companies making more changes.

Another factor that might affect IFRS policy choices was investigated: size. Taking Germany as an example, small listed companies choose significantly different IFRS policies from the largest companies. The above findings on national patterns and on country groups for larger companies would probably be even clearer for smaller companies (ie for most companies).

10.2 RECOMMENDATIONS

Several recommendations and policy implications follow from the findings in this report. First, there are still very large differences between IFRS and US GAAP. It is not clear that the SEC was wise to remove the reconciliation requirement for foreign registrants. Analysts should note that it is dangerous to compare IFRS and US financial statements without adjustment.

Secondly, the simplest way for a jurisdiction to implement IFRS is to adopt the IASB's process rather than to absorb or endorse standards one-by-one. Even if jurisdictions do not require entities to comply with 'IFRS as issued by the IASB', they should require auditors to give an opinion on that, assuming that such compliance is intended or allowed. For developing countries with few or no listed companies, it is doubtful whether IFRS is appropriate, and such countries should consider the issue carefully.

Thirdly, multinational companies that use IFRS for consolidated statements might have to wait a very long time before they can use IFRS for all purposes (eg for statutory reporting for most European subsidiaries). Analysts, accountants and auditors should be alert to the many opportunities for different practices within IFRS itself, ie that IFRS statements might not be comparable. Using this report, analysts, accountants and auditors can consult a chart of typical IFRS practices for major countries. Analysts should realise that major international differences in IFRS practices are likely to exist in other topic areas, but these differences may not be observable.

Finally, given the persistence of national patterns of IFRS practice, without any apparent underlying economic need for them, the IASB should continue its efforts to remove options.

10.3 FURTHER RESEARCH

A number of opportunities for further research arise from the discussion in this report. First, Figure 2.3 on page 13 shows a model that is designed to explain the development of different accounting practices in different countries and examples of its potential application are given. Researchers could take an extensive list of countries and examine them over a long period (eg 20 years) in order to see if the model holds in general.

Secondly, Figure 4.1 on page 17 shows methods of implementing IFRS and some examples of countries are given. Researchers could develop a more extensive classification of countries. Similarly, EU member states were classified by their degree of acceptance of IFRS. This could be extended to the rest of the world. An exercise similar to that in Figure 4.1 could be carried out in order to classify ways of implementing the IFRS for SMEs.

Next, there has been no thorough research into different translations of IFRS. It would be useful to examine whether any translation errors or translation difficulties have created important differences between the accounting practices of different countries.

Another area for investigation is the quality of enforcement of standards. Some work has been done (eg in Germany) in the period of voluntary adoption of IFRS. Even so, there is little published research on whether differences in IFRS practice from 2005 onwards might result from poor enforcement in some countries.

This report studies the use of IFRS options by companies from five countries. There is an almost unlimited opportunity for researchers to extend this to other countries. This report concentrates on overtly measurable IFRS options. There might be ways of investigating international differences that arise from covert options and measurement estimations (eg the recognition and measurement of impairment). This report studies IFRS reporting in 2005 and 2008. Future researchers will be able to examine whether the patterns discovered here persist.

Lastly, the classification of Figure 8.1 page 33 (showing country groups by IFRS policy choices) could be extended to include other countries; and the preliminary research into whether smaller German companies make different choices from larger ones could also be extended to other countries.

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RR/124/001

ISBN: 978-1-85908-473-1

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