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SKU: 9781259747984-SOLUTIONS

CHAPTER 2
WORLDWIDE ACCOUNTING DIVERSITY

Chapter Outline

I. Historically, considerable differences have existed across countries in the preparation and presentation of financial statements. These differences can result in significantly different amounts being reported in the financial statements prepared by companies using different GAAP.

II. A variety of economic and institutional factors are thought to have influenced the development of a country's accounting system and cause differences in those systems across countries.
   A. Legal system – In code law countries, accounting rules tend to be legislated; common law countries tend to have a non-legislative organization that develops accounting standards.
   B. Taxation – Financial statements serve as the basis for taxation in many countries. In those countries with a close linkage between accounting and taxation, accounting practice tends to be more conservative so as to reduce the amount of income subject to taxation.
   C. Providers of financing – In those countries in which family members, banks, and the government are the major providers of business finance, there tends to be less demand for public accountability and information disclosure. In countries where shareholders are a major provider of financing, the demand for information made available outside the company becomes greater.
   D. Inflation – Countries with chronic high inflation adopted accounting principles in which traditional historical cost accounting was abandoned in favor of inflation-adjusted figures. This was especially true in Latin America. However, inflation has been successfully brought under control in most countries, and this factor is no longer as important in explaining accounting diversity as it once was.
   E. Political and economic ties – Through previous colonization, a British style of accounting is used throughout most of the former British Empire. Ties between countries also help to explain similarities between financial reporting in the U.S., Canada, and Mexico. Perhaps the most striking example of political and economic ties influencing accounting across countries is the adoption of IFRS for publicly-traded companies in the 27 countries comprising the European Union.

III. National culture is another factor thought to influence the development of a country's accounting system. Using Hofstede's (1980) societal value dimensions, Gray (1988) developed the following hypotheses:
   A. Conservatism hypothesis – Countries high on uncertainty avoidance and long-term orientation and low on individualism and masculinity will foster a more conservative approach to measurement.
   B. Secrecy hypothesis – Countries high in power distance, uncertainty avoidance, and long-term orientation and low on individualism and masculinity will exhibit more secrecy (less disclosures) in accounting reports.
   C. Research results provide some support for these hypotheses, especially the hypothesis that culture affects the level of disclosure in accounting reports.

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IV. Gray's framework has been modified to argue that national culture not only influences accounting rules but also the manner in which accountants apply those rules.
   A. According to this modified Gray framework, accountants are expected to apply financial reporting rules in a fashion consistent with their cultural values.
   B. As a result, accountants' financial reporting decisions should differ between countries because of differences in the cultural values of the accountants applying the rules. This is especially true for those financial reporting decisions that require the application of judgment.
   C. Research provides some support for the hypothesis that culture affects how accountants across countries apply a common accounting standard.

V. Differences in accounting across countries can create several problems.
   A. Consolidating foreign subsidiaries requires that the financial statements prepared in accordance with foreign accounting rules must be converted into parent company GAAP.
   B. Companies interested in obtaining capital in foreign countries may be required to provide financial statements prepared in accordance with accounting rules in that country, which could differ from rules in the home country.
   C. Investors interested in investing in foreign companies may have a difficult time in making comparisons across potential investments because of differences in financial reporting across countries.
   D. Historically, there has existed a lack of quality accounting standards in some parts of the world. The 1997 East Asian financial crisis was at least partially attributable to a lack of high quality accounting in the region.

VI. Historically, there have been two major models of accounting used across countries in the developed world, the Anglo-Saxon (micro-based) model and the Continental European (macro-uniform) model.
   A. The Anglo-Saxon (micro-based) model of accounting is found in common law countries, where there is a separation of accounting from taxation, and outside shareholders are an important source of financing. Information is developed primarily for equity investors, with adequate disclosure serving as a major objective.
   B. The Continental European (macro-uniform) model is used in code law countries, where accounting is more closely linked to taxation, and families, banks and government, rather than outside shareholders, are the major providers of financing. Income measurement is more conservative and disclosure is lower than in the micro-based class of countries.

VII. Nobes introduced a simplified model of the reasons for international differences in financial reporting in 1998. In this model, the class (A or B) of accounting used in a country is a function of the strength of the equity-outsider financing system, which is a function of a nation's culture, including its institutional structures.
   A. Class A accounting systems are oriented toward providing information to outside shareholders (less conservative, more disclosure). This is consistent with the Anglo-Saxon model (micro-based class) of accounting.
   B. Class B accounting systems are geared to taxation and creditors (more conservative, less disclosure, accounting follows tax rules). This is consistent with the Continental European model (macro-uniform class) of accounting.
   C. Nobes suggests that Class B countries that are interested in competing for equity capital will adopt a Class A accounting system if allowed to do so. Accounting developments in Europe over the last 30 years have shown this to be true.

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VIII. Differences in accounting across countries exist in several areas.
- A. Differences in the financial statements included in an annual report – For example, some companies in Austria and Germany provide a “statement of changes in noncurrent assets” in a their set of financial statements.
- B. Differences in the format used to present financial statements – For example, assets are presented in order of liquidity by most companies in the U.S., Canada, Japan, and Mexico, but in reverse order of liquidity by companies in most other countries.
- C. Differences in the level of detail provided in the financial statements – For example, many foreign companies provide a separate column in individual financial statements indicating related notes, whereas this practice is virtually unknown in the U.S.
- D. Terminology differences – For example, Bermuda-incorporated Jardine Matheson refers to accounts receivable as “debtors” and inventories are called “stocks and works in progress.”
- E. Disclosure differences – For example, companies in some countries provide extensive disclosures related to their employees.
- F. Recognition and measurement differences – For example, several different models exist internationally to measure property, plant, and equipment subsequent to acquisition: historical cost (HC), historical cost adjusted for changes in the general purchasing power of the national currency (GPP), and fair value (FV).

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Answers to Questions

1. Companies in North America (United States, Canada, and Mexico) commonly present assets in order of liquidity, beginning with cash; companies in Europe commonly present assets in reverse order of liquidity, often beginning with intangible assets.

2. The two major types of legal systems are “code law” and “common law.” Code law countries tend to have an accounting law, which is rather general and does not provide much detail. In common law countries, a non-legislative organization generally develops accounting standards, which tend to provide much more detail than is found in the accounting laws of code law countries.

3. In those countries in which published financial statements form the basis for taxation, there is an incentive for companies to minimize financial statement income so as to also minimize income taxes. This incentive does not exist in those countries in which expenses taken for tax purposes are not required to be recognized in the financial statements.

4. The major providers of financing are equity investors (shareholders), banks, family members, and government. As equity financing becomes more important in a country so does the disclosure of information available to the public. It is not feasible for a company to allow hundreds and thousands of investors access to internal accounting records.

5. Financial reporting in the Anglo-Saxon model of accounting was oriented toward meeting the decision needs of large numbers of investors and creditors. This model was used in most English-speaking countries and other countries heavily influenced by the United Kingdom or the United States. Most of these countries follow a common law legal system. The Continental European model was used by most of Europe, Japan, and other code law countries. Companies in this group usually were tied quite closely to banks that served as the primary suppliers of financing. Because these are code law countries, accounting was legalistic and designed to provide information for taxation or government-planning purposes.

6. According to Gray’s cultural accounting framework, the particular way in which a country’s accounting system develops is influenced by accountants’ accounting values and by the country’s institutional framework, both of which are influenced by cultural values. Thus, national culture is viewed as affecting accounting systems indirectly in two ways: through its influence on accounting values and through its institutional consequences.

7. Strong uncertainty avoidance countries are hypothesized to favor conservative measures of profit and assets following from a concern with security and a perceived need to adopt a cautious approach to cope with uncertainty of future events. They are also hypothesized to prefer secrecy (less disclosure) following from a need to restrict information so as to avoid conflict and competition and to preserve security.

8. The Anglo cultural area is expected to favor less conservatism and more disclosure, and the less developed Latin cultural area is expected to favor more conservatism and less disclosure.

9. The modified Gray framework hypothesizes that national culture affects the manner in which accountants apply accounting standards, and therefore differences in national culture will cause accountants to apply a common accounting standard differently. This implies that differences in financial reporting across countries would continue even if all countries followed the same set of standards.

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10. Worldwide accounting diversity causes additional complexity for MNCs in the preparation of consolidated financial statements on the basis of parent company GAAP. Each foreign subsidiary must either keep two sets of books—one in local GAAP and one in parent company GAAP—or the foreign subsidiary's local GAAP financial statement must be reconciled to parent company GAAP. Accounting diversity also complicates MNCs gaining access to foreign capital markets, as investors and lenders in foreign countries might require financial statements prepared in local GAAP. A third problem for MNCs caused by worldwide accounting diversity relates to a lack of comparability of financial statements when making foreign acquisition decisions. The MNC might need financial statements for the potential acquisition target prepared in accordance with a set of accounting standards with which the MNCs managers are familiar and that fairly present operating performance and financial position.

11. Comparison of companies across countries for making portfolio investment decisions is complicated by the diversity in accounting practice that exists worldwide. There is a so-called "apples and oranges" problem associated with trying to directly compare a company that uses one set of accounting standards to measure income and report financial position with another company that uses a different set of accounting standards.

12. Nobes (1998) argues that the two most important factors influencing differences in accounting systems across countries are (a) nature of culture and (b) type of financing system. Nobes' notion of culture appears to go beyond the rather narrow notion in Gray's framework to include institutional structures found in a country. Countries that are culturally dominated by a country with a self-sufficient culture are expected to have an accounting system similar to the dominant country. Some cultures lead to strong equity-outside shareholder financing systems, and other cultures lead to weak equity-outside shareholder financing systems. Countries with a strong equity-outside shareholder financing system use a Class A accounting system in which measurement practices are less conservative, disclosure is extensive, and accounting practice differs from tax rules. Countries with a weak equity-outside shareholder financing system use a Class B accounting system in which measurement is more conservative, disclosure is not as extensive, and accounting practice more closely follows tax rules.

13. Nobes's simplified model suggest that as the financing system in a country evolves from weak outside equity to strong outside equity, countries with a Class B accounting system will evolve toward the use of Class A accounting. In addition, as companies in a Class B country become more interested in outside equity financing, they will evolve toward the use of a Class A system of accounting. This model is consistent with the evolution of financial reporting in the European Union over the last 3 decades:

    - In the 1990s, to allow companies to be more competitive in attracting international equity investment, Austria, France, Germany, Italy, and Switzerland (European countries with Class B accounting systems) gave stock exchange-listed companies the option to use International Financial Reporting Standards (IFRS), a Class A accounting system, in preparing their consolidated financial statements. Large numbers of German and Swiss companies, in particular, took this opportunity to use IFRS.
    - This desire for companies to be competitive in the international capital market ultimately led the European Commission in 2005 to require all publicly traded companies within the European Union (EU) to use IFRS in preparing consolidated financial statements.

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14. Financial statements can differ across countries in terms of:
    a. which individual financial statements are included in a set of financial statements;
    b. the format used to present individual financial statements;
    c. the level of detail provided in financial statements;
    d. terminology;
    e. disclosure requirements; and
    f. recognition and measurement rules.

15. Cost of goods sold is comprised of materials, labor, and overhead. In a type of expenditure format income statement, such as that presented by Südzucker AG in Exhibit 2.10, separate line items for *cost of materials*, *personnel expenses*, and *depreciation* are presented in the income statement. In addition, the line item *change in work in process and finished goods inventories and internal costs capitalized* adjusts for the manufacturing costs included in *cost of materials*, *personnel expenses*, and *depreciation* that are not part of the cost of the inventory that was sold in the current year.

16. A statement of added value added presents information on the "value added" created by the company and the distribution of this value added to employees, banks, stockholders, government, and others. In other words, this statement provides some insight into the groups that benefit most from the company's existence.

17. Property, plant, and equipment (PPE) can be reported on the balance sheet subsequent to acquisition at:
    a. historical cost (this is required in the U.S. and Japan),
    b. historical cost adjusted for changes in the general purchasing power of the currency (this is required by IFRS in hyperinflationary countries), and/or
    c. fair value (this is allowed by IFRS).

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Solutions to Exercises and Problems

1. a.

	Callaway	Südzucker	Meliá Hotels	Thai Airways	Tesco
Gross profit margin					
Gross profit	385,011	N/A	N/A	N/A	3,018
Revenues	871,192	6,476.0	1,801,962	178,312,499,436	55,917
	44.2%	N/A	N/A	N/A	5.4%
Operating profit margin					
Operating profit	44,168	440.9	175,746	N/A	1,280
Revenues	871,192	6,476.0	1,801,962	178,312,499,436	55,917
	5.1%	6.8%	9.8%	N/A	2.3%

N/A – information for the numerator of the ratio is not provided in the company's income statement, and therefore the ratio cannot be calculated

Gross profit margin cannot be calculated for Südzucker, Meliá Hotels, or Thai Airways because gross profit is not disclosed separately. These companies use a type of expenditure format income statement. This might be true for Meliá Hotels and Thai Airways because gross profit is not a meaningful concept.

Operating profit margin cannot be calculated for Thai Airways because operating profit is not disclosed separately.

b. In addition to the obvious caveat about comparing profit margins across companies operating in different industries, an analyst must also be careful in directly comparing profit margins across countries because of differences in the rules governing the recognition and measurement of revenues and expenses in calculating profit. For example, the only two companies for which gross profit margin can be compared—Callaway Golf and Tesco—use U.S. GAAP and IFRS, respectively, to prepare their financial statements.

2. The solution to this exercise will depend upon the companies selected for examination. Instructors might want to forewarn students that depending upon the companies selected, it might not be possible to identify five differences for parts c. and d.

Note: As an alternative to allowing students to select companies for comparison, instructors might want to assign specific companies, for example, two companies in the same industry. One possible combination of companies for which numerous differences exist is Nucor Corporation (U.S.) and Salzgitter AG (Germany), both of which are steel makers.

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3. The solution to this exercise will depend upon the companies selected for examination.

4. Gray's secrecy hypothesis – high secrecy = high PD, high UA, low IND, low MASC, high LTO

High Secrecy	**PD** ***High***	**UA** ***High***	**IND** ***Low***	**MASC** ***Low***	**LTO** ***High***	**#**
Belgium	**High**	**High**	High	High	Low	2
Brazil	**High**	**High**	Medium	High	**High**	3
Korea	**High**	**High**	**Low**	**Low**	**High**	5
Netherlands	Low	Medium	High	**Low**	**High**	2
Sweden	Low	Low	High	**Low**	Low	1
Thailand	**High**	Medium	**Low**	**Low**	High	3

Assuming that each cultural dimension is equally important in influencing the accounting value of secrecy, the number of dimensions on which each country's index is consistent with a high level of secrecy could be summed as shown in the far right column above. Using this approach, Korea would be expected to have the highest level of secrecy, followed by Brazil and Thailand, then Belgium and the Netherlands. Sweden would be rated as having the lowest level of secrecy.

Note that there could be some disagreement with respect to rating each country's level on each cultural dimension as high, medium, or low, but the overall conclusions should not be substantially different from those presented above.

5. Completing this assignment requires students to integrate the information in the chapter on factors affecting accounting development. There are no absolutely correct responses. Some of the factors that might be relevant are presented below:
   Austria – Japan, Germany family – Germanic culture, influenced by Germany.
   Brazil – Spain, Belgium, France, Italy family – former Portuguese colony, Latin cultural area – actually belongs in a separate Latin American family of accounting as shown in Exhibit 2.7.
   Finland – Sweden family – Scandinavian culture, former Swedish possession, economic ties to Sweden.
   Ivory Coast – Spain, Belgium, France, Italy family – former French colony – perhaps part of a Francophone African family of accounting comprised of former French colonies in Africa.
   Russia – unclear as to where Russia would fit in – historically it would have been in a completely separate class of accounting based on the soviet system.
   South Africa – U.K. influence family – former British colony – possibly with Netherlands, as South Africa was Dutch prior to becoming British.

6. The response to this exercise will depend upon the student's home country. U.S. students should mention (1) the importance of the equity market (strong equity-outside shareholder financing system), (2) the separation of taxation and financial reporting, and (3) the fact that accounting standards (GAAP) are developed by a non-governmental entity (FASB) as important factors influencing accounting in the United States. Historical ties to the U.K. also could be mentioned.

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7. There are no absolutely correct answers to these questions. Different opinions among students can generate an interesting debate.
   a. Possible answers include: lack of comparability of financial statements across countries, additional work for MNCs to prepare consolidated financial statements, lack of high quality financial reporting in some countries.
   b. Possible answers include: international investors, international lenders, MNCs.
   c. It might be easier for MNCs to deal with the problem of preparing worldwide consolidated financial statements than for international investors and creditors to deal with issues of non-comparability or low quality financial statements. The reason is that MNCs have the internal information needed to reconcile their foreign subsidiaries financial statements to a common GAAP, whereas investors and creditors generally do not have access to internal information to be able to make financial statements comparable or of higher quality.

8. There are no absolutely correct answers to these questions. Different opinions among students can generate an interesting debate.

   Two issues to consider are (1) how strong is the influence each factor exerts on accounting and (2) how likely is it that these factors will change over time. For example, if taxation exerts a very strong influence on financial reporting in some countries and it is highly unlikely that the governments in those countries will separate taxation from financial reporting, then taxation represents a relatively large impediment to convergence in those countries.

9.

Babcock International Group PLC
Company Balance Sheet
March 31, 2017

Assets	
Current assets	
Accounts and other receivables	3,049.2
Noncurrent assets	
Investment in subsidiaries	2,359.5
Total assets	5,408.7
Liabilities and Stockholders' Equity	
Current liabilities	
Accounts and other payables	1,820.4
Noncurrent liabilities	
Accounts and other payables	1,281.9
Total liabilities	3,102.3
Common stock	303.4
Additional paid-in capital	873.0
Appropriated retained earnings for capital redemption*	30.6
Other appropriations of retained earnings*	768.8
Retained earnings	330.6
Total stockholder's equity	2,306.4
Total liabilities and stockholders' equity	5,408.7

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9. *(continued)*

* Because appropriations of retained earnings are not commonly reflected on the balance sheet in U.S. financial reporting, it is unclear what these line items would be called by a U.S. company.

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Case 2-1 The Impact of Culture on Conservatism

Part I.
If cultural values affect the development of financial reporting rules, and countries differ with respect to cultural values, then financial reporting rules will differ across countries. If financial reporting rules are strongly influenced by culture and cultural values do not change significantly over time, culture acts as an impediment to reducing differences in financial reporting rules that exist across countries.

Part II.
Even if all countries agreed to use the same financial reporting standards (harmonization), to the extent that application of those standards involves judgment, cultural differences could lead to differences in the application of those standards. For example, in applying a rule that requires recognition of a contingent loss when its realization is "probable," accountants in more highly conservative countries might err on the side of conservatism by establishing a lower probability threshold than would accountants in less conservative countries.
Other areas in which culture might lead to differences in the application of financial reporting rules include areas in which estimation and judgment are involved: warranty expense, bad debt expense, revenue recognition, asset impairment tests, obsolete inventories, etc.

Part III.
Cancan's internal auditors need to be aware that accountants in these different countries might have culturally-determined biases in the way that they apply the company's accounting policies. Accountants in Brazil and Korea are likely to be more conservative (higher UA, lower IND) in applying Cancan's accounting policies than the accountant in Sweden (lower UA, higher IND). The internal auditor needs to plan to conduct tests to determine whether this bias is operating. Contingencies, warranty expense, bad debt expense, revenue recognition, asset impairment tests, and obsolete inventories are all areas that require considerable judgment. In addition, the accountants in Brazil and Korea may be less willing to provide information requested by the internal auditors because of a higher level of secrecy.

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Case 2-2 SKD Limited

1. ***Goodwill***
   a. There is no goodwill amortization expense in Country A, so the goodwill amortization expense recognized by SKD must be added back to determine income under Country A GAAP.
   SKD amortizes goodwill over a longer period (20 years) than is allowed in Country B (5 years), so an additional amount of goodwill amortization expense must be recognized to determine income under Country B GAAP, which reduces Country B GAAP income.
   b. The goodwill adjustment affects the retained earnings in stockholders' equity. The increase in Country A GAAP income results in an increase in retained earnings and the decrease in Country B GAAP income results in a decrease in retained earnings.
   c. The adjustment to income is for the current year only. The adjustment to stockholders' equity is cumulative. The fact that the stockholders' equity adjustment is three times as larger as the income adjustment implies that the goodwill was purchased three year ago.

2. ***Capitalized Interest***
   a. The adjustment labeled "Capitalized interest" relates to the interest that is not expensed but instead is capitalized under Country A GAAP. The adjustment labeled "Depreciation related to capitalized interest" relates to the depreciation of the interest that was capitalized as part of the cost of the asset.
   b. The first adjustment increases income because interest is not being expensed immediately but instead is capitalized as part of the cost of the asset to which it relates. The second adjustment decreases income because under Country A GAAP, the asset to which interest is capitalized has a larger cost and therefore a larger depreciation expense.
   c. Both income adjustments are closed out to retained earnings and partially offset one another. The increase to income of $50 and the decrease of $20 result in a net increase in retained earnings of $30.

3. ***Fixed Assets***
   a. When fixed assets are revalued to a higher amount, there is an increase in their carrying value with an offsetting increase in stockholders' equity to keep the balance sheet in balance. The amount by which the assets are revalued is subject to depreciation, which results in a larger depreciation expense. The adjustment to recognize this additional depreciation expense decreases income under Country B GAAP. It also decreases stockholders' equity (retained earnings). The decrease in retained earnings from additional depreciation is smaller than the increase in stockholders' equity from revaluation of assets, which results in a net increase in stockholders' equity. Note: if we knew when the fixed assets were revalued, we could determine the amount by which they were revalued. For example, if revaluation occurred at the end of the previous year, then the revaluation amount must have been $64 ($64 – $8 = $56) because only one year of additional deprecation would be included in the stockholders' equity adjustment.

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