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**A COMPARATIVE STUDY AND CRITICAL
EVALUATION OF GROUP ACCOUNTING IN
GERMANY, FRANCE AND THE UNITED
KINGDOM.**

**THE LIMITATION OF QUANTITATIVE
ANALYSIS**

A thesis submitted to Middlesex University in partial fulfilment of the
requirements for the degree of Doctor of Philosophy.

HILARY JACK FORTES

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ABSTRACT

The importance of a form of international accounting standard has been well documented over the past twenty years. In the area of research the predominant focus has been on the measurement of the degree of harmonisation between countries. This research, whilst qualitative in nature, has, in the main, relied on a quantitative assessment of accounting practices in the countries being reviewed. In doing this, reliance has been placed on surveys, questionnaires and reviews of financial statements. Each has its own set of problems. This is all illustrated and highlighted in the literature survey where argument and counter argument is evident over twenty years.

In all this, little has been done to review the foundation from which the data is extracted and it is argued that the very aspect of a qualitative work has been ignored completely in favour of the more high profile quantitative research.

The research sets out to investigate whether, in point of fact, there is a need to undertake a more searching and detailed examination of accounting practices in each country before any attempt is made of a measurement study or a classification study. Clearly the answer is that this must be done as only in so doing can the playing field be levelled and can the very basis for measurement or classification be fully understood in advance.

It was necessary to undertake a full sampling of groups of companies in the three member states and to draw the smaller sample from those final lists. This was to prevent any aspect of bias being present and to ensure that only random sampling was undertaken in the final selection. The initial response to requests for financial statements and the subsequent follow ups resulted in a staggering response of 77% over the three member states and from these a sample equivalent to approximately 20% was drawn for further analysis. It is to be hoped that with further funding and additional resources, further investigation can be conducted into the remainder of the sample which would be brought up-to-date.

The results of the research indicate positively that the qualitative work must be undertaken first and foremost and that any quantitative work can only be of value if cognisance is taken of the many diverse problems that can, and do, arise in accounting practice. These problems are detailed in the research and while not claiming to be exhaustive, they nevertheless provide an imposing array of the multitude of problems that do arise in undertaking either a measurement study or a classification between countries.

This work fills an important gap in the literature and examines an area not covered by previous research. It highlights the underlying problems of quantitative work and while not attempting to underrate that work, it nevertheless suggests that research of a qualitative nature should not be ignored or undervalued.

The thesis consists of nine chapters together with a number of appendices. The chapters are designed to underpin the base of knowledge of the five accounting practices dealt with in the thesis and to explain the workings of the important bodies who have played a vital role in accounting harmonisation. Even as the concluding words are written the European Commission is moving ahead with their plan for a more harmonised Europe. They are joined by the International Accounting Standards Committee who are moving ahead in their plan for a world-wide set of accounting standards.

Chapter 1 introduces the study while Chapter 2 explains why this area of research was undertaken. Chapter 3 examines the literature dealing with both measurement and classification studies. The investigation of the three member states naturally requires an understanding of the workings of the European Union and this is dealt with in Chapter 4 while Chapters 5 and 6 examine the Directives issued and the diversity of accounting practice within the three member states. This is accompanied by a more in-depth discussion on the five accounting practices, which are the subject matter of the work. Chapter 7 takes a deeper look into the accounting practices of France, Germany and the United Kingdom before moving on to Chapter 8 which examines the five topics of deferred taxation, foreign currency translation, goodwill, leases and pensions. This chapter analyses the

sample groups of listed companies so as to determine if the original hypothesis was ~~in fact correct~~. The chapter concludes with a number of lessons to be learnt from each of the five topics. Chapter 9 analyses these lessons and draws a conclusion, which is well illustrated by a list of problems that have been deduced from this work.

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TABLE OF CONTENTS

Abstract	i
Acknowledgements	iv
Contents	v
List of Tables	xi
List of Figures	xiv
Bibliography	332
Appendix	358
Chapter 1 INTRODUCTION, DEFINITIONS AND OUTLINE.....	1
1.1. Introduction.	1
1.2. History of financial reporting.	2
1.3. The influence of taxation.	4
1.4. The importance of the topic.	5
1.5. The selection of issues for examination.	5
1.6. Research design.	8
1.7. Study limitations.	8
1.8. Thesis outline.	9
Chapter 2 WHY THE RESEARCH?	11
2.1. Why the EU?	11
2.2. Why these three countries?.....	12
2.3. Why examine harmonisation?.....	16
2.4. Why the need to examine group accounts?	19
2.5. Measurement and disclosure.	20
2.6. Write up on data assembly.....	22
Chapter 3 AN EXAMINATION OF LITERATURE RELEVANT TO THE RESEARCH.	28
3.1. Introduction.	28
3.2. Data sources.....	30
3.2.1. International surveys.....	30
3.2.1.1. PriceWaterhouse surveys (PW).	31
3.2.1.2. Gray, Campbell and Shaw.	39
3.2.1.3. Cairns, Lafferty and Mantle.....	40
3.2.1.4. Stilling, Norton and Hopkins.....	40
3.2.1.5. International Accounting Standards Committee (IASC).....	41
3.2.1.6. Tonkin.....	41
3.2.1.7. Fédération des Experts Comptables Européens (FEE).....	42
3.2.1.8. National surveys.	44

3.2.1.9.	Administered questionnaires.....	45
3.2.1.10.	Questionnaires.....	46
3.2.1.11.	Published financial reports.....	48
3.2.2.	Conclusion on use of data.....	53
3.3.	International research studies.....	54
3.3.1.	International harmonisation measurement studies.....	55
3.3.2.	European harmonisation measurement studies.....	57
3.4.	Definitions.....	60
3.5.	Indices and statistical methods.....	66
3.6.	Conclusions of past research.....	76

Chapter 4 ACCOUNTING ACROSS NATIONAL FRONTIERS THE NEED FOR FURTHER HARMONISATION..... 83

4.1.	The European Union.....	83
4.2.	Institutions of the European Union.....	87
4.2.1.	The Commission.....	87
4.2.2.	The Council.....	88
4.2.3.	The European Parliament.....	88
4.2.4.	The Courts of Justice.....	89
4.3.	The legislative process.....	90
4.3.1.	Regulations.....	91
4.3.2.	Directives.....	91
4.3.3.	Decisions.....	91
4.4.	The European Monetary System.....	92
4.5.	Accounting practices.....	93
4.6.	Accounting Directives.....	95
4.6.1.	The 4 th Directive.....	95
4.6.2.	The 7 th Directive.....	97
4.7.	Accounting differences.....	98
4.8.	Accountancy profession.....	100
4.9.	The future.....	102
4.10.	The legal system.....	104
4.11.	Financial statements.....	106
4.12.	Conclusion.....	108

Chapter 5 THE DIVERSITY OF ACCOUNTING PRACTICES, STANDARDS AND THE TRUE AND FAIR VIEW..... 110

5.1.	Introduction.....	110
5.2.	Is the valuation gap closing?.....	110
5.3.	The true and fair view.....	111
5.3.1.	The origins of the true and fair view.....	111
5.3.2.	The introduction to the 4 th Directive.....	115
5.3.3.	Interpreting the true and fair view.....	117
5.4.	National accounting standards.....	120
5.4.1.	France.....	123
5.4.2.	Germany.....	123
5.4.3.	United Kingdom.....	124
5.5.	International Accounting Standards Committee.....	124

5.6.	Valuation methods.....	130
5.6.1.	Intangible fixed assets.....	131
5.6.2.	Foreign currency translation.....	132
5.6.3.	Pensions.....	134
5.6.4.	Deferred tax.....	134
5.6.5.	Leases.....	136
5.7.	Conclusion.....	136
Chapter 6	THE EUROPEAN ACCOUNTING DIRECTIVES.....	137
6.1.	An introduction to the 4 th Directive.....	137
6.2.	Principles of the 4 th Directive.....	138
6.3.	The effects of the Directive on harmonisation.....	138
6.4.	Contents of the 4 th Directive.....	139
6.4.1.	Accounts must present a true and fair view.....	140
6.4.2.	Valuation rules.....	141
6.5.	Tax influence on accounts.....	143
6.6.	Accounting treatment excluded from the 4 th Directive.....	144
6.6.1.	Deferred tax.....	144
6.6.2.	Pensions.....	144
6.6.3.	Leasing.....	145
6.6.4.	Translation of foreign currency.....	145
6.7.	Conclusion.....	146
6.8.	An introduction to the 7 th Directive.....	146
6.9.	Principles of the 7 th Directive.....	148
6.10.	Definition of a group.....	149
6.10.1.	Preparation of consolidated accounts.....	151
6.10.2.	Exemptions from the preparation of consolidated accounts.....	152
6.10.3.	Uniform accounting policies.....	152
6.10.4.	Exclusions from consolidation.....	153
6.10.5.	Associates and joint ventures.....	154
6.11.	Fair value.....	155
6.12.	Conclusion.....	155
Chapter 7	A REVIEW OF ACCOUNTING IN FRANCE, GERMANY AND THE UNITED KINGDOM.....	157
7.1.	Introduction.....	157
7.2.	France.....	157
7.2.1.	Legal system.....	157
7.2.1.1.	Commercial Code.....	158
7.2.1.2.	The Plan Comptable Général.....	159
7.2.2.	Forms of ownership.....	163
7.2.3.	History of financial reporting in France.....	164
7.2.4.	Regulatory bodies.....	167
7.2.5.	Professional bodies.....	170
7.2.6.	The tax system.....	173
7.2.7.	Consolidated accounts.....	175
7.2.8.	Finance.....	179
7.2.9.	Conclusion.....	181

7.3.	Germany.	182
7.3.1.	Legal system.	182
7.3.1.1.	E.C. Directives.	183
7.3.1.2.	Charts of accounts.	185
7.3.1.3.	The Commercial Code.	187
7.3.2.	Forms of ownership.	188
7.3.3.	History of financial reporting in Germany.	191
7.3.4.	Regulatory bodies.	194
7.3.5.	Professional bodies.	194
7.3.6.	The tax system.	195
7.3.7.	Consolidated accounts.	198
7.3.8.	Finance.	200
7.3.9.	New developments.	202
7.3.10.	Conclusion.	203
7.4.	The United Kingdom.	205
7.4.1.	Legal system.	205
7.4.2.	Forms of ownership.	206
7.4.3.	History of financial reporting in the UK.	207
7.4.4.	Regulatory bodies.	209
7.4.4.1.	Accounting standards.	211
7.4.5.	Professional bodies.	213
7.4.6.	The tax system.	214
7.4.7.	Consolidated accounts.	215
7.4.7.1.	History of consolidation.	216
7.4.7.2.	Definition of a subsidiary.	217
7.4.7.3.	Definition of associated companies.	218
7.4.7.4.	Exemptions from consolidation.	220
7.4.8.	Finance.	221
7.4.9.	Accounting policies, standards and rules.	222
7.4.10.	New developments.	223
Chapter 8	AN EXAMINATION OF DISCLOSURE AND MEASUREMENT PRACTICES IN FRANCE, GERMANY AND THE UNITED KINGDOM.	224
8.1.	Introduction.	224
8.2.	An evaluation of the measurement and disclosure practices used in accounting for deferred tax.	224
8.2.1.	Introduction.	224
8.2.2.	Methods.	226
8.2.3.	The European dimension.	227
8.2.4.	International standards.	228
8.2.5.	US standards.	228
8.2.6.	France.	229
8.2.7.	Germany.	229
8.2.8.	United Kingdom.	230
8.2.9.	The future.	232
8.2.10.	Review of sample groups.	233
8.2.11.	France.	234

8.2.12.	Germany.	235
8.2.13.	UK.	235
8.2.14.	A review of the results.	236
8.3.	An evaluation of the methods adopted and disclosed in foreign currency translation.	238
8.3.1.	Introduction.	238
8.3.2.	Methods.	239
8.3.3.	The European dimension.	241
8.3.4.	International standards.	243
8.3.5.	US standards.	244
8.3.6.	France.	245
8.3.7.	Germany.	246
8.3.8.	United Kingdom.	248
8.3.9.	Review of sample groups.	251
8.3.10.	France.	252
8.3.11.	Germany.	253
8.3.12.	UK.	255
8.3.13.	A review of the results.	255
8.4.	An evaluation of the disclosure practices made on goodwill.	256
8.4.1.	Introduction.	256
8.4.2.	Methods.	257
8.4.3.	The European dimension.	258
8.4.4.	International standards.	259
8.4.5.	US standards.	260
8.4.6.	France.	260
8.4.7.	Germany.	262
8.4.8.	United Kingdom.	262
8.4.9.	Review of sample groups.	266
8.4.10.	France.	266
8.4.11.	Germany.	268
8.4.12.	UK.	269
8.4.13.	A review of the results.	271
8.5.	Accounting for leases - an evaluation of the current practices.	274
8.5.1.	Introduction.	274
8.5.2.	Methods.	275
8.5.3.	The European dimension.	276
8.5.4.	International standards.	278
8.5.5.	US standards.	278
8.5.6.	France.	279
8.5.7.	Germany.	280
8.5.8.	United Kingdom.	280
8.5.9.	The future.	284
8.5.10.	Review of sample groups.	285
8.5.11.	France.	286
8.5.12.	Germany.	287
8.5.13.	UK.	289
8.5.14.	A review of the results.	290

8.6.	An evaluation of the disclosures made on pension and post retirement benefits.....	291
8.6.1.	Introduction.....	291
8.6.2.	The type of schemes.....	292
8.6.3.	The type of benefit plans.....	293
8.6.4.	Funded and unfunded schemes.....	295
8.6.5.	The European dimension.....	296
8.6.6.	International standards.....	298
8.6.7.	US standards.....	300
8.6.8.	France.....	301
8.6.9.	Germany.....	303
8.6.10.	United Kingdom.....	306
8.6.11.	The future.....	309
8.6.12.	Review of sample groups.....	311
8.6.13.	France.....	312
8.6.14.	Germany.....	313
8.6.15.	UK.....	315
8.6.16.	A review of the results.....	317
Chapter 9	SUMMARY AND CONCLUSION.....	318
9.1.	Introduction.....	318
9.2.	Summary.....	320
9.3.	The lessons learnt.....	323
9.4.	The future for harmonisation.....	325
9.5.	Limitations of this research.....	326
9.6.	Scope for future research.....	327
9.7.	A review of the problems uncovered.....	328
9.8.	Conclusion.....	331

LIST OF TABLES

Table 2.1	Companies in The Times Top 500	13
Table 2.2	Other major countries in The Times Top 500	13
Table 2.3	Market Capitalisation of Domestic Equity	14
Table 2.4	Listed companies at 30 April 2000.....	15
Table 2.5	Financial institutions excluded from top 500 sample.....	24
Table 2.6	Statistical data: List of Sample by Country and Size	25
Table 2.7	Value of capital employed in sample institutions.....	26
Table 2.8	Table of countries and sectors	27
Table 3.1	The Division of Harmonisation	29
Table 3.2	Details of the three Price Waterhouse surveys.....	32
Table 3.3	Details of category changes of PW surveys	33
Table 3.4	Details of researchers using PW surveys.....	34
Table 3.5	Amended responses used by Da Costa, Bourgeois and Lawson	34
Table 3.6	Use of Published Financial Statements by Researchers	49
Table 4.1	Designations of Private and Public Companies.....	108
Table 5.1	The history of the true and fair view in the 4 th Directive	116
Table 5.2	Percentage of intangible value to equity.....	131
Table 6.1	A Comparison of EC Accounting Directives and International Accounting Standards.....	137
Table 6.2	Comparison of Profit Achieved and Profit Sensitivity.....	139
Table 6.3	Comparison of Return on net assets	139
Table 6.4	A division of rules	142
Table 6.5	Exclusions from consolidation	154
Table 7.1	A summary of the composition of the PCG	160
Table 7.2	A summary of the account structure within the PCG.....	161

Table 7.3	Determination of a large company.	172
Table 7.4	Determination of the small company.....	172
Table 7.5	Criteria for consolidation.....	177
Table 7.6	Selection by major French groups of accounting standards for consolidation of accounts.	178
Table 7.7	Details of new listings and capitalisation values on French stock exchange.....	180
Table 7.8	Development of securities market showing number of companies	180
Table 7.9	The French Markets.....	181
Table 7.10	The size determination of a company.....	190
Table 7.11	Disclosure requirements for companies	190
Table 7.12	Generally accepted accounting principles	194
Table 7.13	Criteria for the preparation of consolidated accounts.....	199
Table 7.14	Summary of filing requirements for UK companies	206
Table 7.15	Size limits for companies in the UK.....	207
Table 7.16	Treatment of investments for consolidation purposes.....	220
Table 7.17	Categorisation of companies and groups.....	220
Table 8.1	The methods of providing for deferred tax.....	227
Table 8.2	Evidence of the use of deferred tax.	227
Table 8.3	The history of deferred tax in the UK	231
Table 8.4	Effects of the use of a full provision for deferred tax on EPS.....	233
Table 8.5	The use of the main methods of foreign currency translation of balance sheet items.	242
Table 8.6	The use of the main methods of foreign currency translation of profit and loss items.....	243
Table 8.7	Results of Survey of Large French Groups	246
Table 8.8	Results of Survey of Large German Groups	247

Table 8.9	Translation of foreign financial statements	251
Table 8.10	Results of Survey of Sample Group	256
Table 8.11	Disclosure of capitalised goodwill on consolidation.....	258
Table 8.12	Amortisation of capitalised goodwill on consolidation.....	259
Table 8.13	The amortisation period in France.....	261
Table 8.14	Disclosure of the accounting policy used for goodwill on consolidation.....	272
Table 8.15	Disclosure of economic life used for amortisation of goodwill	272
Table 8.16	Volume of leasing.....	275
Table 8.17	Financial lease activity and disclosure	277
Table 8.18	Lease activity and Profit and Loss disclosure	277
Table 8.19	Types of pension plans	293
Table 8.20	Disclosure of pension provisions.....	297
Table 8.21	The six components of pension cost.....	301

LIST OF FIGURES

Figure 1	Harmonisation and Standardisation.....	64
Figure 2	The continuum from diversity to uniformity.....	99
Figure 3	The division of accounting rules	121
Figure 4	The subdivisions of the PCG.....	160
Figure 5	The source of accounting standards.....	167
Figure 6	The Structure of the FRC	210
Figure 7	Accounting profit versus taxable profit.....	225
Figure 8	The translation of foreign financial statements in Europe.....	241

CHAPTER 1

INTRODUCTION, DEFINITIONS AND OUTLINE.

1.1. INTRODUCTION.

Financial reports are nearly always complicated documents reporting on complicated entities. As a result there is an ongoing need to interpret them and in order to be able to do so there is the requirement of adequate information. Users who do not understand the complexities of financial reporting will not understand the message that financial reports intend to convey. Any attempt that may be made to simplify financial reporting so as to give a simpler message runs the risk that users who do not understand the underlying complexity may not understand the messages being communicated. All this is further aggravated by the publication of abridged financial statements and the indicated plan of the Accounting Standards Board in the UK to allow companies to offer an even simpler set of financial information.

While messages communicated by the financial statements are not always taken into account, users must understand the limits and use sensible techniques to review the accounts. The range of judgement in a report where it is capable of giving different views must be narrowed or even eliminated. Users read what they want, and use, for example, earnings per share, as a factor to judge the value of a company or group. It is not possible to eliminate the range of judgements contained in the financial report nor does the user, often a layman, realise that a 'true and fair view' is a view and not a certainty.

The development of financial statements has essentially been by trial and error. They have evolved by observing the best current practices and innovations, and imitating them. At certain key points in accounting history, the courts, or more recently, regulatory bodies have made pronouncements; or new statutory provisions have been introduced. But such court decisions and new legislation have simply followed and codified developing practice.

1.2. HISTORY OF FINANCIAL REPORTING.

The earliest attempts to record financial information as detailed in Bull (1990), dates back to Assyria of 3500 BC while the Greek and Roman periods show advances in the art of record keeping. The adoption of money as a normal medium of exchange took place during the 5th and 6th Centuries BC.

The Arab traders of the 7th to 11th Centuries provided a stimulus for the use of double entry. They used two clear columns and moved away from the narrative form previously in use. The first double entry records were said to be in Italy in the 14th century and the first accounting text of 1494 was written by Luca Pacioli in Venice.

In 1605 the practice of ascertaining profit at the year-end instead of at the end of each venture was first proposed and the 19th Century expansion of trade gave an added impetus to accounting development. Minimum standards were established and the profession was formed. In addition, the appearance of shareholders in limited companies became evident.

Accounting evolved from a simple straightforward art of the 1950s to the strife-torn, complex field of today. Flegm (1991), is of the view that accounting has a rich, controversial history, filled with compromises, subjectivity and judgement.

As the economic and social systems require more complex accounting, accountants and users of financial reports increase in number and sophistication. With this increase in the number, complexity and size of firms, their need for more capital grows and intensifies. This in turn demands more complex accounting and increases the number of people who can use and understand financial accounts.

In tracing the history of accounting Flegm (1991, p.361) concludes that the relevancy, as opposed to the reliability of accounting financial data, has been the subject of dissertations and textbooks since the advent of absentee ownership of companies and the subsequent growth of the stock markets as major sources of capital early in this century.

Although annual reports represent a small subject of the 'accounts' created by an organisation, they are the company's official public documents and this provides a focus for accountability. Indeed, annual reports in the opinion of Elitzur and Amernic (1992, p.31) may be viewed as mass communication devices.

In dealing with the history of accounting in the three member states with which this thesis is concerned, it must be noted that each of the three countries has evolved over different routes. In the main each of the three member states has adopted a different approach to accounting.

In examining France and tracing it back to its beginnings of 1673 (see Chapter 7), the importance there has always been the way in which the records are maintained. Great emphasis is laid on what information is contained in the books of account and this is regulated by the Plan Comptable Général. Output was never regulated and the financial statements are seen to be merely a by-product of the recording within the books. Only the books of account and the rewards obtained by the proprietors were of interest and here it may be because of the nature of ownership where undertakings were family or state owned. In either event there was sufficient 'inside' knowledge which precluded the need for detailed financial statements.

It is evident that valuation as an issue cannot follow from the way in which transactions are recorded in the books of account - transactions would be recorded at the time of the transaction and at the amount paid using the normal methods of double entry.

In the case of Germany another aspect has to be brought into focus and this is its very strong link with taxation. Because of this the input into the books as well as any output is highly regulated by the tax authorities and therefore the accounting measurement methods are determined accordingly.

In the continental countries regulation has traditionally been centred on the maintenance of such records, the organisation of company accounting systems and the procedures and controls for processing accounting documentation. Resulting from this there has been a development of classification schemes (chart of

accounts) where accounting transactions and events are standardised (in bookkeeping terms) to particular account codes. These charts are by their very nature strongly biased towards financial accounting and have statutory backing. Where tax driven accounting is in place then the use of charts is linked to the structure of the company's annual return and is used for completion of the tax returns.

In the UK the focus of accounting was and still is on output i.e. on the published accounts. An important reason is that there has always been the need for financial statements to be presented to the shareholders and other users. It was only in this way that management could account to their shareholders. Until the creation of the European Union no law existed which regulated the form and content of this output. The UK was therefore self-regulatory and developed its own accounting standards, company law, etc.

The thrust of regulation in both company law and accounting standards has always been on the preparation of published financial statements. Very little focus has been placed on the detail of internal company accounting records.

In dealing with the history of accounting in the three member states it must be noted that they have evolved over different routes and have in the main been based on the different approaches by the three member states to accounting. There are three very definite underlying philosophies - each member state having its own very distinctive way of approaching the topic of accounting. As a result accounting today is shaped by, and reflects the characteristics of the particular country; it's personal traits and values. For this reason chapter 7 examines in some detail present accounting practice in France, Germany and the UK.

1.3. THE INFLUENCE OF TAXATION.

Tax law is on many occasions considered to be the only reason for accounting. Under a legalistic approach accounting rules are contained in the law. While in one country a government can be active and take a dominant role in accounting legislation, in other countries the accountancy profession is often weak.

In the years since the 1950s there has been an increasing emphasis on the provision of accounting information for management with its primary focus on the provision of greater analysis and presentation. But this has, in no way, resulted in the diminution of the tax influence on accounting.

1.4. THE IMPORTANCE OF THE TOPIC.

Many areas of research do not allow one to quantify the benefits. In a similar vein it is not possible to determine the costs or benefits of accounting harmonisation. As stated previously there is the need for the presentation of accounts given the globalisation of world markets and the use of these accounts in making decisions. Ideally these accounts should be based on comparable rules and regulations.

This need for international harmony is not only apparent to major accounting firms (Gokarn, 1984) but also to international groups, such as the International Organisation of Securities Commissions (IOSCO), an international body of securities regulators who indicated their support of the IASC and their work (See Chapter 5).

The development of a stock market does influence the country's reporting practices and the conservative/less conservative approach to profit disclosure can also be influenced by stock market orientation.¹

1.5. THE SELECTION OF ISSUES FOR EXAMINATION.

The 4th Directive was a document of compromise and as such there were many issues not addressed. Van Hulle (1992, p.167) lists these as including, foreign currency translation, leasing, deferred taxation, etc.

In selecting the topics to be reviewed in this thesis, reliance was made on the work undertaken by the FEE (1990a, pp.15–20).

¹ Gray (1980) suggests that the orientation of the UK environment may account for the less conservative approach to profit measurement of UK companies when compared to other European countries.

In the work they list various aspects covered by IASs and not, or insufficiently referred to by the 4th Directive.

Their list considers, in the first instance, items dealing with valuation principles:

- Long-term contracts,
- Tax on profits.
- Leasing contracts,
- Pensions and similar charges,
- Grants,
- Accounting for foreign currency,
- Capitalisation of borrowing costs, and
- Acquisitions by exchange.

It also deals with items under the heading of disclosure principles:

- Changes in financial position,
- Segment reporting, and
- Related party disclosures.

In a further work by FEE (1990b) the conclusions contained in that work are used in order to further determine the topics to be examined in this thesis.

In the work by the FEE (1990b) they state that they will develop a separate paper on long-term contracts. In reviewing accounting treatment on the tax on profits it is 'questionable whether it is useful to study this subject in more detail although it might be worthwhile to express a preference for accounting for deferred taxation.'

In the case of both leasing and foreign currency translations, the 4th Directive working party had already completed a study at the time.

In considering pensions the FEE stated (1990b, p.142) that there is a 'certain degree of uncertainty when examining annual accounts' because pension obligations do not exist in all countries. While they considered that no further work should be undertaken there would ultimately be harmonisation when the social regulations of the member states came closer together.

In the case of grants, capitalisation of borrowing costs and acquisition by exchange they concluded (FEE, 1990b, pp.142-143) that 'it did not seem worthwhile to study this subject further.'

Finally when dealing with the disclosure issues the FEE (1990b, pp.144-145) were of the opinion that the information could be 'limited to that required by the 4th Directive.'

In view of all the above it was decided that consideration be given to the items listed under valuation principles and that because of the FEE statements cited above, grants, capitalisation of borrowing costs and acquisition by exchange would be eliminated from consideration, together with long-term contracts. It was furthermore felt that in view of their statement on taxes on profit, this area would be looked at under the heading of deferred taxes.

As the thesis revolves around the examination of consolidated accounts, one further topic which arises by virtue of the grouping together of undertakings had to be introduced. That topic was the one of goodwill.

This then was the rationale for the choice of topics in this thesis.

With increasing globalisation and the resulting narrowing of the market place there is an ever-increasing need for better communication. This need brings into question the problems associated with the understanding of the company and group accounts. This is vital if the strategic role of capital in the economic development

process is to be highlighted. All this will allow for the improved flow of funds and the raising of any additional funds that may be required.

1.6. RESEARCH DESIGN.

In designing the chosen method of research for this thesis cognisance had to be taken of both time and cost factors. In Chapter 3 details are given for the reasons why the use of surveys can be justified but at the same time the many disadvantages are listed. Other methods of assembling information are also considered although also excluded. These include interviews, which would require extensive resources to interview in three countries.

The archival technique of data collection seemed to be the most reliable and cost effective although extremely time consuming. Again there were certain downsides to this method and these are fully dealt with in Chapter 3. The advantage of using annual reports is that the material has not been prepared for purposes of this thesis and therefore there can be no bias in the data. This may be the case where individuals are interviewed or where questionnaires are used in a survey.

In using the data from annual reports the support offered by Tay and Parker (1990, pp.84-85) was used. In their work they stated that 'if harmonisation activities are the result of concern about the comparability of accounts produced by companies from different countries, then a measurement study should focus on actual reporting practices rather than regulations, that is, on de facto rather than de jure harmonisation.' They continued by suggesting that 'actual reporting practices may be assessed most accurately from annual accounts, or detailed surveys of such accounts.'

1.7. STUDY LIMITATIONS.

Using only three member states obviously limits the scope of the study. In addition the number of companies covered is only a sample of the listed companies in each country. In Chapter 2 it is shown that there is no sector bias, but it would be wrong

to attempt to generalise or extrapolate the findings of this thesis beyond the confines of the countries covered.

As the study only deals with current reports, that too, does not allow for more extensive interpretation. Although accounts are normally prepared on a consistent basis there is an understanding that certain accounting policies and regulations were only recently introduced and have, possibly, only been employed in the year under review. It is for this very purpose that only a one-year review has been utilised, as this affords a commentary on current practices and not on the movement towards harmonisation.

1.8. THESIS OUTLINE.

Chapter 2 examines the reasons for choosing this particular area of research. It asks and answers questions on why France, Germany and the United Kingdom were chosen and examines the sample of the companies selected for the research.

Chapter 3 reviews the relevant literature. The chapter examines the research undertaken in comparative international accounting and the examination practices in financial reporting. It also reviews the research of various measurement practices as it relates to harmonisation.

Chapter 4 reviews the need for harmonisation and examines the background of the European Union, its legislative processes and the effects of accounting directives.

Chapter 5 focuses on the diversity of accounting practices in France, Germany and the UK. It examines the treatment of various accounting transactions, which are dealt with in more detail later in Chapter 7. The true and fair view is also explained and examined, as are valuation methods. The work on international accounting standards is explored and introduced into the thesis.

Chapter 6 brings into play the European accounting directives that particularly affect accounting harmonisation and deals in some detail with the way in which

directives are implemented and the effect that they have on international harmonisation.

Chapter 7 focuses on the three countries of the investigation; France, Germany and the UK, and examines the accounting background of each, their legal framework and the various accounting topics selected for review and which form the subject of this thesis.

Chapter 8 deals with the details of the accounting treatment of the chosen topics in each of the three member states and introduces the current accounting treatment in the United States as well as the practice adopted by the International Accounting Standards Committee. It takes the data from the financial reports and subjects it to further examination and ultimate discussion.

Chapter 9 presents the results of the examination and the lessons to be learnt. It summarises the findings of the research and makes suggestions for further research.

CHAPTER 2

WHY THE RESEARCH?

In choosing the topic as well as the three countries of France, Germany and the United Kingdom for this thesis various questions arise as to why each individual aspect was selected. As a start each one of these aspects is examined.

2.1. WHY THE EU?

Under the various European treaties one of the principal aims of the EU is the establishment and effective operation of a common market, economic and monetary union and an ever-closer union among the peoples of Europe. To do this the EU has gone through a process of steady enlargement and now with fifteen member states, is a major trading bloc. The common market is to be achieved by the free movement of goods, persons, services and capital. Member states are to develop common economic policies of fair competition, environment, consumer protection, research and development, transport, energy, agriculture and external trade. The fundamental freedom of movement applies not only to individuals but also to companies that pursue an economic objective.²

The treaties³ that helped create the European Union can be summarised as:

- 1958 - Treaty of Rome (1 January) which established the EEC between six original members. It built on a number of principles and institutions developed within the European Coal and Steel Community created in 1952. The EEC covered a whole range of economic activity that has subsequently been increased by amending treaties.

² Article 58 of the Treaty of Rome.

³ Treaties are a source of constitutional law of the EU. They set out the objectives of the EU, create its institutions and regulate its functioning.

- 1987 - The Single European Act (SEA) (effective from 1 July) increased the influence of the European Parliament and helped the rapid creation of the internal market.
- 1993 - Treaty of European Union ('Maastricht Treaty') (1 November) created the EU. It is often described as a 3-pillar structure consisting as it does of the EC with political co-operation:
 - In foreign and security policy;
 - In justice; and
 - In home affairs.
- 1997 - The Amsterdam Treaty was signed in July after an 18 month process. The Treaty does have its critics with many believing that it does not go far enough especially with institutional changes. It does allow for majority voting rather than the cumbersome unanimity decisions that were needed previously. The Treaty also enhances the role of the European Parliament giving it a greater say in the shape of future legislation.

2.2. WHY THESE THREE COUNTRIES?

The three member states chosen are seen as leaders within the EU in that:

- they are major industrialised countries with well established capital markets;
- they are members of the IASC; and
- they also have a large proportion of companies appearing in The Times Top 500 list of companies of Europe (See Tables 2.1 and 2.2). This in spite of their differing cultures and legal systems.

Table 2.1 Companies in The Times Top 500

Number of Companies (The Times 1998)			
	France	Germany	UK
Sample list	55	61	101
Excluded financial institutions	<u>23</u>	<u>14</u>	<u>32</u>
Total per country	78	75	133

Table 2.2 Other major countries in The Times Top 500

Other Major Countries (The Times 1998)		
	Total Companies	Financial institutions
Switzerland	37	17
Sweden	30	4
Italy	30	15
Netherlands	26	11
Belgium	19	9

When examining market capitalisation it is apparent that the three member states chosen are the top three in the list of European Stock Exchanges (see Table 2.3).

Table 2.3 Market Capitalisation of Domestic Equity

Market capitalisation on Main European Stock Exchanges (excluding investment trusts, listed unit trusts and UCITS)	
	<i>ECU (millions)</i>
London	1956258
Frankfurt	930841
Paris	837061
Zurich	591265
Amsterdam	512445
Rome	484030
Madrid	342486
Stockholm	239063
Brussels	210322

[Source: European Stock Exchange Statistics, Federation of European Stock Exchanges, Annual Report, December 1998]

Another reason for choosing these three member states was to select the largest stock exchanges (by number of listed companies), ensuring that there was a mix between domestic and foreign companies (see Table 2.4).

Table 2.4 Listed companies at 30 April 2000

	Domestic	Foreign	Total
London	2321	498	2819
Paris	982	169	1151
Frankfurt	662	245	907
Amsterdam	224	149	373
Madrid	812	11	823
Rome	261	6	267
Stockholm	276	21	297
Brussels	162	149	311

[Source: Federation of European Stock Exchanges]

It was considered that these exchanges would be situated in the countries with a greater probability of multiple listings and therefore there would be a greater incentive for international harmonisation.

Cross country differences in measurement affect comparability of resulting accounting data and Europe is good for this. Germany and the UK are in the view of Mueller, Gernon and Meek (1997) the originators and most experienced examples of the two primary accounting philosophies world wide:

- Anglo-Saxon; and
- Continental models.

Differences between the chosen member states include:

- the method of financing companies and corporate governance;

- the importance of taxation in financial reporting;
- the degrees of development of the accounting profession; and
- the cultural differences.

Under the Anglo-Saxon model equity holders expect a true and fair view and there is no formal binding tax/accounting link. Under the Continental model the focus is on the lenders of finance, codified reporting and a strong, explicit formal tax/accounting link. This was adequately illustrated in Blake, Amat and Fortes (1996).

Although France is traditionally closer to Germany it has according to Joos and Lang (1994) shifted towards the Anglo-Saxon model.

An analysis of Germany, France and the UK permits a comparison of the effects of two relatively 'pure' and one intermediate example of common alternative approaches to accounting measurement.

2.3. WHY EXAMINE HARMONISATION?

Harmonisation is intended to ensure that there is an equivalence of disclosure as well as a uniformity of practice across member states. In the preamble to the 4th Directive it states that competing companies should be subject to equivalent legal conditions.

The Directive also states that harmonisation is an aid to creditor protection and competition by multinational corporations. According to Diggle (1996), at no stage is 'standardisation' used in the Directive.

With the growth in cross border dealings between companies and in the run up to achieving this common market, these differences were becoming more inconvenient. Harmonisation of company law at European level is essential to establish protection throughout the community and to ensure that the interests of shareholders, employees, creditors and third parties are safeguarded.

The way forward was thought to consist, inter alia, of the harmonisation of accounting practice by member states. This in itself provides an interesting focus for harmonisation as the EU through its directives is able to enforce the adoption of standards on member states while international bodies such as the OECD and the IASC can only recommend or suggest various standards.

Every country has its own accounting rules and standards. These are influenced by:

- the legal and economic systems of the country;
- its culture and tradition; and
- the degree of development within the country.

Whatever the standard it is imperative that comparability and relevance are contained within these standards.

Comparability can only exist where all companies within a country use similar standards. This, however, does not exist internationally and great diversities in standards are evident between countries. With the growth of international business activity and international investment, there is an ongoing demand for greater comparability in standards.

There is the ongoing and ever-increasing need for high-quality and harmonised accounting. In the past 20 years, because of increasing globalisation of business, the case has become more compelling and pressures for international harmonisation have become urgent. As new countries join the EU and as companies adapt their businesses to become European or global companies rather than single nation companies, more and more multinationals are being created. Global trade has also exerted a certain influence on harmonisation through the increase of foreign involvement in businesses, etc.

Linked with this is the increasingly global nature of capital markets. Multinationals need to raise capital in many different countries and having access to the capital markets will assist. The companies believe that in so doing they will increase their

share of world business. Financial reporting is the cornerstone on which the process of capital allocation is built. It promotes and encourages innovation, provides an efficient market for buying and selling of marketable securities and is also vital in assisting companies in their quest for additional funding.

Choi and Levich (1991) tried to gauge the extent of the support for harmonisation existing among the investment professionals. The main finding was that about half of the respondents felt that diversity in accounting affects market decisions while the remainder had either been able to cope with this diversity or felt that the lack of uniformity was not a significant problem. They concluded that the accounting differences are important and affect investment decisions of a significant number of market participants.⁴

All the regulators surveyed by Choi and Levich (1991) felt that accounting diversity did not affect capital market decisions but they nevertheless supported harmonisation because of competition between markets. Regulators are pursuing the need to find acceptable accounting principles and disclosure levels. They believe that by adopting a set of international standards one national capital market will not be at a disadvantage to any other in its competitive bid to attract foreign issuers of equity.

Privatisation has also created demands for capital and the size of these companies is often too great for the capital market of one country. This once again requires companies to go beyond their domestic markets in the search for capital.

This globalisation (both in business and capital markets) has created the necessary impetus and pressure for establishing international accounting standards. Pressure from users and preparers of financial statements and from securities regulators and stock exchanges are but some of the areas which drive the forward movement to international standards.

⁴ It was observed that some investors restated foreign GAAP statements but that did not remove the problem of lack of uniformity.

The IASCs objective is to improve and harmonise standards of financial reporting. In July 1995, the IASC reached an agreement with IOSCO on a joint work programme with the aim of producing, in the medium term, a core set of international accounting standards to be applied by companies seeking a multinational listing of securities [see Chapter 5].

Since the statement, the European members of IOSCO, strongly supported by the SEC, have urged the IASC to accelerate the completion of its work programme. The IASC resolved in March 1996, to try and complete its programme by mid 1998 which was almost achieved leaving only one aspect of the core standards to be dealt with in January 1999. The standards are to include a core set of pronouncements that will constitute a comprehensive generally accepted basis of accounting and are anticipated to be of high quality, result in comparability and transparency and provide full disclosure.

It is the view of Bryan Carsberg, Secretary-General of IASC, that there is a strong case for internationalisation in accounting and that the resulting international global standards will bring 'prizes for everybody'.⁵

2.4. WHY THE NEED TO EXAMINE GROUP ACCOUNTS?

The 7th Directive adopted in 1983 concerns consolidated accounts and defines undertakings whose accounts must be consolidated. The basis for consolidation is the legal power of control exercised by a parent company over its subsidiaries. It stipulates that its control is either by holding a majority of voting rights or the right to appoint the majority of the board or by specific contract.

Consolidations are not tied to domestic standards and as a result companies are able to re-define and re-modify the way of presentation and the accounting principles and practices used. While individual accounts are, in many member states, directly related to the need to report for tax purposes and to the assessment of profit available for distribution, groups are not separate legal entities and therefore they

⁵ Carsberg, B, delivering the 1998 Founders' Lecture 'The Internationalisation of Accounting' (17 June 1998) to the Institute of Company Accountants.

are not involved in being classified as taxable entities. Where a member state has tax driven accounting (such as Germany) then they should be able to redraft accounts in the consolidations ignoring the tax effects.⁶ In addition, it is the consolidated accounts of a group that are read by the users who need to see an overall picture of the group.

2.5. MEASUREMENT AND DISCLOSURE.

In Chapter 3 the literature survey deals with the many works on measurement and disclosure. It examines research methods used for obtaining information and for the measuring of such information.

Measurement practice needs to meet two criteria:

- Annual reports must contain sufficient disclosure to determine the policy choice selected; and
- Policy choices must significantly affect measures of net assets and/or profits.

Measurement of the extent of harmonisation needs to be done but not by combining measurement and disclosure practices. There is a need to distinguish between the two (Hussein, 1992).

The method that could be used is an examination of annual reports with no reliance placed on survey data as used, for example, by Nair and Frank (1980), McKinnon and Jannell (1984) and Douppnik and Taylor (1985). Although by using PW surveys (1973, 1975 and 1979), there is not the need of having to collect the statistical information, there are limitations in using the survey data, because of errors and misleading answers (Nobes, 1981).

⁶ It must be noted that after nearly 18 months of discussions, Germany passed an accounting reform law that allows German companies to use US GAAP or IASs for their consolidated accounts. This allows the abandonment of the double accounting of the past where companies like Daimler Chrysler had to disclose divergent earnings using HGB and US GAAP or IAS. A similar situation exists in France where it too has agreed to the use of non-French accounting standards in consolidations.

The use of published financial reports also has its problems and these are not only time-related ones or those revolving around the need to ensure a high level of response to the sample. Other problems are, for example, translations of European financial statements to English (where a translation does not exist or where it is desirable to ensure that the English 'convenience' translation does reflect a correct version of the original language).

Archer et al (1995) believe that translations are 'reports written to what are perceived to be international standards.' If use is made of English versions of German and French data, it may be incomplete or presented in a different form from the original statements. To overcome this constraint, this thesis examines a sample of such reports to ascertain if this is, in fact, true and, if so, the extent and degree to which the financial statements are affected.

Besides the differentiation between harmonisation and standardisation, the basic concept of harmonisation is interpreted in different ways. Two types of harmonisation have been determined (de jure and de facto), and it has been shown that it is possible to have one without the other (Tay and Parker, 1990).

Although this study is of a qualitative nature, investigation is still made of the utilisation of the methods of measurement of comparability and harmonisation as developed by van der Tas (1988 and 1992a). He described harmonisation by coupling de jure as 'formal' and de facto as 'material' harmonisation.

Tay and Parker (1990, pp.74-75) were of the opinion that 'taking account of both the desirability of international comparability of financial statements and the operational difficulties involved in measuring processes rather than states, the most suitable concept for measurement appears to be *de facto* harmonisation ...'.

Research evidence suggests that, in general, indices are the most appropriate way of measuring harmonisation relative to alternatives such as percentage compliance rates and non-parametric tests as used by Nair and Frank (1980).

Van der Tas broke new ground through the use of indices. In support of his own method he approached harmonisation from the point of view of the sort of transaction or event rather than compliance with international accounting standards and used the analogy between concentration and harmony to apply methods of measuring concentration to a similar measure for harmony. A concentration index (the Hirschman-Herfindahl index) used by economists to measure business concentrations, can also be used to measure harmonisation in accounting methods. Van der Tas indicated problems with the H index and overcame this with his introduction of the C index.

Only van der Tas methodology falls into Tay and Parker's de facto harmonisation category. They conclude (1990, p.85) that a measurement study should focus on actual reporting practices rather than regulations, that is on de facto rather than de jure harmonisation.

In this thesis, although the actual measurement of harmonisation is not its objective, the methods used are examined to understand the base from which these measurement studies are derived.

2.6. WRITE UP ON DATA ASSEMBLY.

Actual company data is taken from the most recent annual reports available for 1998/99 year ends. The companies used are taken from The Times Top 500 list as published in the 1998 edition of The Times 1000 (Compiled by FT Information Ltd).

The basis on which The Times lists were prepared is as follows:

In the past years The Times 1000 were listed according to turnover. There were advantages such as the simplicity in compiling - figures were provided by companies and they were universally understood. The disadvantages were that property companies were excluded from the list, as they had no obvious turnover; and the lists were biased in favour of agencies and traders with substantial billings.

Other measures also had their weaknesses - profits, market capitalisation, number of employees, etc.

The lists are now compiled according to a FT Extel formula that they believe addresses most of the disadvantages. The formula is a measure of capital employed that is defined as:

- Shareholders funds, plus
- long-term loans (where separately disclosed), plus
- intra-group payables, plus
- deferred liabilities.

The Times identifies each company as belonging to a sector. This sector is to overcome the various listings given to a company on different stock exchanges. The sample has used the sector listings as given by The Times in order to maintain uniformity. Exclusions of companies listed under sectors described as Banks, other financials, insurance, merchant banks and investment trusts resulted in a total of 69 companies being disregarded in the sample.

Table 2.5 Financial institutions excluded from top 500 sample

List of excluded institutions			
	France	Germany	U.K.
First 100	13	6	6
101-200	2	3	6
201-300	3	1	8
301-400	3	2	4
401-500	2	2	8
Totals	23	14	32

In ranking companies by the amount of capital employed, the FT has converted all foreign currency to Pounds Sterling. The exchange rate used is as close as possible to that ruling at the year-end of each company. For this reason any calculations made within this work has also been made using the same criteria.

Having excluded the aforementioned companies the following table indicates those remaining:⁷

⁷ 27 Companies (including private companies) have also been excluded.

Table 2.6 Statistical data: List of Sample by Country and Size

Top 500	France	Germany	U.K.
First 100	15	16	12
101-200	13	9	20
201-300	9	11	26
301-400	8	16	24
401-500	10	9	19
Totals	55	61	101

In order to prevent any bias as regards size of sample for each country the lowest denominator was used. This resulted in a provisional list being prepared consisting of 55 French companies, 61 German companies and 101 UK companies as shown in the above Table 2.6

Using the sample size as detailed above, the value of capital employed is shown in Table 2.7 below.

Table 2.7 Value of capital employed in sample institutions

	Capital employed £000,000s		
	France	Germany	UK
Highest	53132	61621	52468
Upper Quartile	8417	9891	4498
Median	3906	3126	2666
Lower Quartile	1754	1973	1837
Lowest	1115	1183	1138

A further investigation was undertaken to ensure that there was no sector bias and this is detailed in Table 2.8 below.

All the companies on the selected list were contacted in writing or by telephone with a subsequent follow up by telephone or fax. Because of various delays in receiving the annual reports there was a further follow up in order to ensure that the most recent annual reports were made available.

The findings of this thesis are based on an analysis of the consolidated financial accounts of companies based in France, Germany and the United Kingdom.

A total of 217 companies were contacted which was based on the lists above. Responses received were as follows: Germany (79%); France (80%); and UK (75%). This resulted in an overall total response of 168 companies or 77% of the original list selected.

Wherever possible only the English version financial statements were used subject to the caveat stated previously. With the exception of twelve companies all those contacted had an English version of their annual accounts available. Where no

English versions were available, then the accounts were translated. This was the case in three French companies and nine German companies. In addition, three German 'English' version accounts and one French 'English' version accounts were compared with the original home language version.

Table 2.8 Table of countries and sectors

Analysis of companies in sample by countries excluding financial institutions				
Country	France	Germany	U.K.	Totals
Aerospace	3		2	5
Brewers	3		6	9
Building	7	4	4	15
Business Services	2			2
Communications	2	1	4	7
Chemicals	2	4	2	8
Conglomerates		1	4	5
Electronics	2	3	2	7
Engineering		8	2	10
Electricity	1	9	6	16
Food	6	1	7	14
Health	1	3	4	8
Hotels	2		5	7
Metals	2	5	1	8
Mines	1	2	2	5
Media	2	1	4	7
Oil	3	3	8	14
Other	4	3	2	9
Packing			1	1
Property	2		6	8
Stores	3	2	8	13
Textiles	1		1	2
Tobacco		1	1	2
Transport	5	10	10	25
Water	1		9	10
Totals	55	61	101	217
	<i>credit based</i>	<i>credit based</i>	<i>capital based</i>	

CHAPTER 3

AN EXAMINATION OF LITERATURE RELEVANT TO THE RESEARCH.

3.1. INTRODUCTION.

In research methodology (Chadwick, Bahr and Albrecht, 1984, p2) '... knowledge is advanced through the careful collection, proper analysis, and competent interpretation of research data. ... no research findings are better than the methods used to obtain them.' In this chapter the main literature relevant to this thesis is reviewed to provide an insight into previous work on the general problem of harmonisation⁸ as well as into the area of measurement.⁹

In reviewing the literature relating to the subject area of this thesis, the reader is led through the relevant articles that have been written in the area of harmonisation both within the European Union and internationally. The literature written in the area of measurement, where there is an ever-increasing use of empirical data and objective statistical tools of analysis for all types of international accounting research, is also examined. The review is intended to provide a framework for the study; to highlight findings of previous research on general areas; and to help illustrate relevant research.

Although the past 15 years has witnessed a great expansion in output of literature on financial reporting and international accounting harmonisation, a large part of this output deals with the general state of accounting in one or more countries while other works examine specific accounting issues that are relevant to international accounting. These writings are descriptive, and are not included in this survey which examines two distinct areas:

⁸ There is a need to examine and understand important issues or ideas pertaining to harmonisation and standardisation of financial reporting practices.

⁹ This literature review also has as one of its functions, the establishment of appropriate research methodology and research procedure for this thesis.

1. Literature dealing with the nature and extent of disclosure of accounting harmonisation; and
2. Literature dealing with the methods used for the measurement of accounting harmonisation.

Studies of harmonisation¹⁰ and its measurement are attempts to measure the actual level of harmony¹¹ existing in the reporting practices of different countries and companies within those countries. The studies are developed from the research classification undertaken on a country. With the increased interest in harmonisation of international accounting standards, research focused on measuring whether financial accounting across nations was moving towards a more compatible or harmonised position. The measurement is based on reported measurement policies of the samples selected as, for example, in the works of van der Tas (1988 and 1992a) and Emenyonu and Gray (1992).

Before dealing with the relevant writings it is important to draw some distinction between the use of the term harmonisation. The table below attempts to do just that.

Table 3.1 The Division of Harmonisation

Accounting Harmonisation	
ACCOUNTING REGULATION	ACCOUNTING PRACTICES
<i>De jure</i> harmonisation (Tay and Parker)	<i>De facto</i> harmonisation (Tay and Parker)
Formal harmonisation (Van der Tas)	Material harmonisation (Van der Tas) ¹²
Harmony of accounting rules and standards	Harmony of actual financial reporting practices

¹⁰ A study of harmonisation can be carried out at a national level or at an international level, or both.

¹¹ The study can measure harmony at a single point in time or at several points in time.

¹² Formal harmonisation is defined as the degree of similarity existing among the sets of financial standards of various nations. Material harmonisation refers to the degree of similarity among financial reports of enterprises. Formal harmonisation would be above material harmonisation in a hierarchical sense because the former provides a means of accomplishing the latter.

In examining harmonisation measurement studies these can be subdivided into:

- Those that assess compliance with international accounting pronouncements notably IASs or EC Directives; and
- Those that deal with measuring and determining levels of harmony in the accounting practices of various countries.

In this chapter the review is biased towards studies that have relevance to the issue of international harmonisation and to ways of measurement of such harmonisation.

3.2. DATA SOURCES.

There are many different sources from which information can be obtained for use in harmonisation research studies. These include international and national surveys and published financial reports. Ancillary sources would include questionnaires and interviews. These sources are not without their critics and this is detailed in the review below.

3.2.1. INTERNATIONAL SURVEYS.

The main purpose of this type of survey is to compile data on financial reporting practices of more than one country at a point in time. Where the data is limited to one country then this is shown under National surveys (section 3.2.2). Surveys have certain advantages as a data source for researchers:

1. The tedious and time-consuming work has already been done or minimised.
2. There is no need for collecting data.
3. There is no need to worry about any language barriers.

As a result researchers have the opportunity of examining several countries in a shorter space of time.

There are also disadvantages:

1. Other researchers question the suitability and reliability of the surveys. (Tay and Parker, 1990, Nobes 1981).¹³
2. The answers to the surveys, though strictly true, can be misleading if taken out of the context of the survey.

Notwithstanding all this these surveys continue to be used by researchers. These surveys can be divided into various groups. This is done in the following pages and incorporates a review of each type of survey together with the perceived advantages and disadvantages of each.

3.2.1.1. PRICEWATERHOUSE SURVEYS (PW).

This is one of the most widely quoted sources of survey data. PriceWaterhouse (PW) undertook a series of International Surveys in 1973, 1975 and 1979. Their stated objective was to gain a better understanding of national accounting principles and reporting practices. PW also felt that these surveys would help in the move towards harmonisation by creating an awareness of the different practices. Their surveys have been used not only for the classification of accounting systems (Nair and Frank, 1980) but in other ways such as testing compliance with International accounting standards (Doupnik and Taylor, 1985).

The survey data was gathered through PW offices situated in the countries surveyed. Uniform procedures were used in collecting, compiling and checking the data. The answers were based in the main on legislation and pronouncements of accounting bodies, stock exchanges and other authoritative bodies at the time. Where there was a diversity of practices in a country then the use of judgement was required. In countries where a lack of publicly available information prevented an

¹³ In the PW data respondents were asked to fit their national accounting practices into a number of categories ranging from required to not permitted. Both category extremes imply the same degree of uniformity and researchers were constrained by the structure of the survey question, which may or may not have been relevant to their research interests.

assessment of the degree of conformity of a given practice, the response given represents the best judgement of PW (Nair and Frank 1981, p.65).

Although the procedures for collecting the data remained consistent, the nature of the possible responses, the number of countries and the number of questions asked over the three periods had changed. This is illustrated in the Table 3.2 below:

Table 3.2 Details of the three Price Waterhouse surveys

Year of Survey	1973	1975	1979
Countries examined	38	46	64
Accounting practices	233	264	267
Scoring scale	1-6	1-7	1-8
Categories	6	7	8

Only 37 countries were common to all three surveys and only 131 accounting practices were identified as having been included in all these three surveys and were common to the survey years. As a result, survey comparisons were difficult to perform and led to Nair and Frank (1981, p.68) being selective in their choice of data and adopting 'a less stringent operational definition of harmonisation...'.

Over the three periods the number of categories into which answers were scored increased from 6 to 8. Table 3.3 details the categories of the three surveys.

Table 3.3 Details of category changes of PW surveys

1973	1975	1979
Required	Required	Required
Majority	Majority	Majority
About half	About half	Predominant practice
Minority practice	Minority practice	Minority practice
No application	Not found in practice	Rarely or not found
		Not accepted
Not permitted	Not permitted	Not permitted
	No application	No application

Users of the PW surveys.

The PW surveys have been the subject of much criticism (see below) but this has not minimised the use of the surveys by many researchers over the years. Table 3.4 shows the use of such surveys over a ten-year period by various researchers, many of whom used the data in their study of the classification of accounting systems, or in harmonisation measurement studies.

Table 3.4 Details of researchers using PW surveys

Researcher	1973 survey	1975 survey	1979 survey
Da Costa, Bourgeois and Lawson (1978)	√		
Frank(1979)	√		
Nair and Frank (1980)	√	√	
Nair and Frank (1981)	√	√	√
Gokarn (1984)			√
McKinnon and Janell (1984)			√
Douppnik and Taylor (1985)			√
Douppnik (1987)		√	

Early classification studies were mainly judgmental (Mueller, 1968) but over the years there have been changes towards the use of empirical data and statistical tools of analysis. The need for data was filled in one respect by the PW surveys.

Da Costa, Bourgeois and Lawson (1978) used earlier works on the delineation of international regions (Russett, 1967) to establish groupings of countries which subscribe to similar accounting practices (this includes accounting principles and reporting practices). In their classification study to 'verify empirically the existence of three accounting models' the authors selected a set of accounting practices and used the PW 1973 survey as their database. They eliminated uniform practices leaving a sample of 100 practices. The responses were ordinally scaled from 1 to 5 on the following basis:

Table 3.5 Amended responses used by Da Costa, Bourgeois and Lawson

Not permitted	Minority use	About 50% use	Majority use	All follow
1	2	3	4	5

As a result the authors showed two groups of countries:

- the distinctly British model, and
- the American model.

They conclude that while international accounting literature shows three groups, 'no group of countries followed a distinctly continental set of practices' and '...the dominant role ascribed to a continental model of accounting appears to be invalid' (Da Costa et al., 1978, p.84).

Frank (1979) in one of the first attempts at empirical classification of accounting systems used the same data as Da Costa et al. (1978) and identified four groups. He then examined these groups to see if they fit in with the social and environmental factors.¹⁴ With 83% falling into the same groupings he established the strong association between financial accounting and environmental variables.

Both of these studies took no account of whether the practices examined were measurement practices or disclosure practices. In Nair and Frank (1980) this separation of variables into measurement and disclosure practices was considered important as it was considered that the two may well be influenced by separate factors and develop on separate lines. They used the 1973 and 1975 PW survey data to determine whether the classification of countries applied to both measurement practices and disclosure practices. Of the 233 practices covered by PW 1973, 147 were measurement practices and 86 were disclosure practices while in PW 1975 the numbers were 162 and 102 respectively. In their subsequent work, Nair and Frank (1981), they added the PW survey of 1979.

¹⁴ The author added a cautionary note that certain countries bear strong affinities with groups other than their own. He checked his results with 'multi-dimensional scaling' which avoids the problems of 'categorical' scoring. It counts the number of times the scores on practices are the same for each possible pair of countries.

The differences in the groups from earlier work confirm that PW's subjectivity in choosing questions is a vital factor to be considered in processing data (Nair and Frank, 1981).

Goodrich (1986) wanted to link the accounting and political practices of 54 countries. To do this he used the PW 1979 survey and from this was able to determine five groups for his classification. His method was criticized because of the way in which the groups were determined. Nobes (1984, p.54) comments on the method used by stating that the 'fact that Goodrich takes the Jersey group seriously is the best illustration of the pitfalls of the empirical method.'

The above classification studies show that accounting development is influenced by economic and political factors and, where countries have similar environments, then the accounting is similar.

Harmonisation measurement studies can be divided into two parts. One is where the researcher assesses the compliance with an international standard such as IASs and the other is where the researcher measures and determines the level of harmony in practices of various countries. In McKinnon and Janell (1984) the former was the case and the PW 1979 survey was used for examining IASC standards.

This was also the case in Doupnik and Taylor (1985) where the PW survey was updated to 1 January 1983 by posting a questionnaire with 53 accounting propositions to the 64 countries in the survey. The updated information was used to measure and compare the level of compliance with the first eight IASC standards at two dates – 1 January 1979 and 1 January 1983.

Doupnik (1987) used the PW data of 1975 and a portion was updated to 1983 in order to be able to compare data for the two periods.

The latter two works saw the use of PW surveys combined with a questionnaire prepared by the researchers but modeled on the PW accounting propositions.

Criticism of the surveys.

The PW data has been the subject of a great deal of criticism and caveats not only by researchers but even by PW itself. In 1979 the PW survey contained a warning (p.3) that it may not contain sufficient details for researchers' needs and the reader was cautioned against too precise an interpretation on specific matters or in relation to specific countries. Consistency is difficult in such a survey especially as the people replying were from different countries with their own cultural and social backgrounds.

This was endorsed by Nair and Frank (1980, p.444) who stated that considerable judgement had to be applied when there was a diversity of practice. This was also the case when there were not that many published financial statements. In their view both of these aspects have an impact on the validity of the data.

Nobes (1981) indicated the limitations of the PW surveys and criticised their use in research.¹⁵ Nobes (1981, p.268) says that Frank (1979) used the PW survey to group accounting systems of various countries and while he 'considers the results more reasonable than those reported elsewhere' (Da Costa et al), neither Frank nor others have checked the reliability of the data or if it is appropriate. Nobes (1984, p.51) comments that Frank 'is much more careful than Da Costa, Bourgeois and Lawson' and furthermore he feels that the 'empirical' work is an advance on previous subjectivity without being concerned with the subjectively collected 'empirical' data.

He noted that the main difficulty of using this data was its appropriateness or validity. He considered the data 'highly subjective, containing misleading answers and obvious mistakes' (Nobes, 1983a, p.2). He highlighted some inconsistencies of

¹⁵ In 1980 Nobes and Matatko reviewed the patterns of classification of accounting systems and prepared an empirical study of accounting practices in 46 countries using PW surveys of 1973 and 1975.

the survey ranging from factual errors to the different types of companies surveyed in the countries.

The work by Nair and Frank (1981) has evoked a great deal of criticism, originally being questioned by Nobes (1981) who felt that the PW surveys were limited in their reliability, not least by their focus on regulations rather than actual practice. Emenyonu and Gray (1992) also questioned the findings because the PW survey focuses on regulation and not practice. Joos and Lang (1994) also consider that use of PW by Nair and Frank does not quantify the effects of the differences in accounting measurement practices because of the limited detail in data.

In questioning the data itself Nobes (1981) lists three aspects where he considers the data as unreliable:

1. There are straightforward mistakes to answers. He pointed out a number of errors in the surveys and cited (p.269) as examples the responses given by the UK practitioners.¹⁶ He concluded that there were possibly similar inaccuracies from responses given by non-UK practitioners which because of the researchers' unfamiliarity with the data source, may have gone unnoticed and may have distorted the findings
2. Some answers, though strictly true, are misleading 'particularly to a computer' (p.268). He cites as an example the impression given that UK or US accounting is as conservative as German accounting and more conservative than the French.
3. Questions are not chosen for the purpose for which the researchers have used them. In his view, to present the survey data in an objective format, a subjective choice of the data must be made by the compilers who often have a different purpose in mind to that of the researchers.

¹⁶ Examples were: stating that in the UK land must be shown separately from other fixed assets, when in fact it is shown with buildings or that only FIFO can be used in stock valuation where SSAP 9 allows other methods.

Nobes (1987) in his criticism highlighted another shortcoming of the surveys. which was that they lacked any precise definitions within certain categories. For example, in the case of 'predominant practice' and 'minority practice' there was no clear understanding as to the percentage of companies that should use the practice for it to be classed in the one group or the other. Tay and Parker (1990, p.80) echoed the criticism by questioning the validity of the data and stated that the questions asked were not for the purposes used by the researchers. In this context Meek and Saudagaran (1990, p.147) said that the surveys 'blur the distinctions between standards and practices.'

In spite of the many criticisms there is still use for such a survey because of its many advantages. Nobes (1984, p.58) concedes that it is a 'rich source of data'.

3.2.1.2. GRAY, CAMPBELL AND SHAW.

Gray, Campbell and Shaw (1984) undertook an extensive survey of 30 countries to understand the differences and similarities in international financial reporting. Information on 430 questions was assembled covering topics such as segmental reporting, foreign currency translation, consolidated accounts and income and asset measurement.

The survey used regulatory requirements (as set out in the legislation of each country at 1 January 1982) and actual company practices (as shown in the financial statements). Deloitte Haskins and Sells were used to interpret the legislation and they surveyed the most recent reports of large companies in each country (50 for major industrialised nations and 20 for less developed nations) to determine actual practice.

The response categories were: required; recommended; permitted and not permitted.

Criticism of the survey.

This survey concentrated on large companies which, being mainly multinational, would report for an international market. It is difficult therefore to determine the extent to which the survey reflected actual accounting practices within the country.

There was also a lengthy time lag between the publication of the survey and the period surveyed. The survey was published in 1984 based on 1982 regulatory information and some of the surveys of recent annual reports were based on accounts issued two or three years earlier.

3.2.1.3. CAIRNS, LAFFERTY AND MANTLE.

Cairns, Lafferty and Mantle (1984) undertook a survey based on 1983 reports of 250 of the world's largest companies in 33 countries.¹⁷ Using a scoring system to allocate marks to each company, this survey was to report on international trends in financial reporting in areas such as consolidation, segment reporting and inflation accounting and also to determine progress in international standard setting. IASs were used to evaluate the measurement and disclosure practices of the companies. The survey found an improvement in reporting among large companies.

Criticism of the survey.

Here again criticism can be made of the fact that the survey was of large companies. The data was presented in an aggregated form without a breakdown of country by country practices. This did not facilitate inter-company comparison by others who may use the data.

3.2.1.4. STILLING, NORTON AND HOPKINS.

Stilling, Norton and Hopkins (1984) surveyed 175 companies in 19 countries at December 1982. The survey's objective was to determine problem areas and show

¹⁷ Earlier work was undertaken by Lafferty and Cairns (1980).

good or unusual practices. The companies were ranked according to a pre-selected criteria: compliance with IASs 1-23 (40%); speed of reporting (20%); provision of voluntary information (20%) and clarity and presentation (20%). The findings (p.4) show that few companies complied with all IAS and 'that the prospects of increased compliance with all international standards in the near future is remote.'

Criticism of the survey.

As with other surveys this one can be criticised for a poor distribution of companies. When five or less companies are sampled from nine countries, then it is difficult to justify including 28 companies from the USA. The authors also caution the reader that their results are 'inevitably biased' due to their 'immersion in the UK approach' (p.3).

3.2.1.5. INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE (IASC).

The IASC also undertook a survey in 1988 to determine the use of IASs in different countries. The survey, in the form of a questionnaire was sent to IASC member bodies in 1987 dealing with various topics. Very few companies disclosed compliance with IASs but the report, without disclosing the extent, stated (p.8) that the level of conformity is 'higher than the level of disclosure'. At the time IASs were extremely flexible and if a company complied with domestic standards then it was quite conceivable that those standards would coincide with an alternative recommend by the IASC. This fact was ignored in the survey.

3.2.1.6. TONKIN.

Tonkin (1989) surveyed 200 of the largest multinationals from 28 countries. The countries were then ranked according to their standard of reporting with the best reporting practice that of the UK. Germany was said to give the best non-financial information. The author felt that there was little improvement of reporting practices over the 1980s and that the differences remained high or had even increased.

Criticism of the survey.

Here again the survey only covered the largest companies and so it is questionable if the reporting practices were representative. In addition it must be questioned if the rankings were also biased to the author's understanding of UK accounting and also his perception of what constitutes good and bad practice.

3.2.1.7. FÉDÉRATION DES EXPERTS COMPTABLES EUROPÉENS (FEE).

The FEE has undertaken a number of surveys. They have been designed to investigate the harmonisation of accounting practices by EU member countries.

[A] In 1989, the FEE published the first survey of European financial statements. The survey compiled by questionnaire was undertaken to determine if the 4th Directive had increased harmonisation in the EU. 191 annual reports for 1987 from nine member states, (Portugal, Spain and Italy of the then existing twelve being omitted) were examined. While large quoted and unquoted companies and multinationals were included small companies (as defined in article 11 of the 4th Directive) were excluded. The survey used 25 annual reports from each member state but in the case of Denmark, Greece and Luxembourg this was a lesser number.

The questionnaire used was adapted from that used by the Dutch Institute of Registered Accountants (NIVRA) for its national surveys of reporting practices.

The survey was in two main sections. While the first section dealt with issues that were covered in the 4th Directive, the second section was concerned with those issues covered in less detail in the Directive and included accounting practices such as deferred taxation; pensions; leasing and foreign currency translation.

Criticism of survey.

The shortcomings of this FEE survey are considered to be sampling, consistency and questionnaire design. The companies were not selected on any statistical basis

but rather through subjective judgement exercised in each country. A large number of people from different countries were involved in the survey and as a result it is difficult to be sure that the treatment in each country was consistent as the skills of the personnel used must differ.

The questionnaire only allowed for positive and negative responses and there was no provision for the fact that a reporting practice might not be applicable to that entity. This flaw was recognised by the FEE and they stated this in their report (p.7).

The survey was based on the 1987 year only and as a result there was no direction or trend shown for comparative purposes. Emenyonu and Gray (1992) are of the opinion that the survey made no attempt to use objective statistical tools of analysis in arriving at its conclusions.

[B] The FEE undertook a further survey into accounting and disclosure practices in 1991. This survey was conducted on the 1989 annual reports of 441 large multinational companies and medium-sized national enterprises in 15 European countries. It was a follow up to the one undertaken in 1989 and did adjust for some of the earlier problems. For example a new specially designed questionnaire was used to gather the information on reporting practices.

The 1991 survey divided the 15 states into three groups:

- Group 1 [EU] where it is compulsory to comply with the 4th Directive. This group consisted of the same member states as those used in the 1989 survey.
- Group 2 where it is not mandatory to comply with the 4th Directive [Italy and Spain].
- Group 3 [non-EU] where the 4th Directive did not apply [Finland, Norway, Sweden and Switzerland].

The topics covered in this survey included the valuation of fixed assets, pension provisions, deferred taxation, foreign currency translation and leasing.

Criticism of survey.

Even allowing for the changes brought about in 1991 inconsistencies in the survey still existed because of the large number of people involved from different cultural backgrounds and skills. This high number can have the effect of distorting the findings. In addition, the sample selection once again allowed room for judgement.

With the use of a new questionnaire a problem arose, which was that the results of the two surveys could not be compared. Neither survey quantified the existence of significant differences in practice and the current status of harmonisation.

[C] Further analysis of the 1991 survey data was made in the 1992 FEE Analysis of European Accounting and Disclosure Practices which was able to distinguish between listed and non-listed companies.

Criticism of survey.

'Inconsistencies within individual countries replies to the questionnaire were identified and responses adjusted as far as possible. It is inevitable however that some inconsistencies still remain...' (FEE, 1992, p.5).

3.2.1.8. NATIONAL SURVEYS.

These surveys are limited to only one country and are intended to highlight the financial reporting practices at a point in time.

National surveys are conducted in many countries and may be either annual reviews or bi-annual reviews. Examples of such surveys are those published annually in the UK by the ICAEW; the Netherlands where NIVRA produces a biennial survey based on questionnaires sent to participating registered accountants¹⁸ and the bi-annual publication by the OEC in France.

¹⁸ The NIVRA survey sends one set of accounts and the questionnaire works through the accounts asking questions about compliance with legal requirements. This is done to monitor the changes in accounting methods.

Van der Tas (1988) utilised national surveys when he set out to quantify harmony and the extent of harmonisation by using the three indices for the measurement of levels of harmonisation. For the UK he used the survey of published accounts of the ICAEW for 1968-1981, while for the Netherlands he used a document entitled Accounting for the WIR (Investment Tax Credit) in the Netherlands (This was introduced in 1978). In the case of the US in researching accounting for investment tax credit (ITC) he used the data from AICPA 'Accounting trends and Techniques' which is an annual publication.

The national survey by NIVRA was also used and adapted by the FEE in compiling their questionnaire for the 1989 survey.

Advantages of national surveys.

As the scope of national surveys is smaller than international surveys they can be more detailed and consequently more reliable than international ones. This was the view of Tay and Parker (1990, p.79) who considered that they were 'generally ...more reliable than international surveys.'

Disadvantages of national surveys.

The bases for compilation of the surveys may make comparisons between countries difficult. Tay and Parker (1990, p.79) also felt that another disadvantage was that the survey might not be in a language familiar to the researcher.

3.2.1.9. ADMINISTERED QUESTIONNAIRES.

This research method was used in order to test the uniformity within each jurisdiction of the application of GAAP and the comparability between jurisdictions.

A hypothetical set of data is prepared and the participants are requested to 'process' it. Accountants in each country are asked to prepare financial statements under local GAAP using the information given.

Walton (1992, p.187) gives examples of empirical testing not previously used in international accounting research. He tested measurement practices by requiring accountants in France and the UK to prepare financial statements drafted in terms of domestic GAAP from a hypothetical set of data. He considered that as the accountants were aware of the data being artificial and without a practical outcome, it may be that the results are not those produced under real-life conditions.

The study by Simmonds and Azières (1989) also makes use of this method. Working with the European network of Touche Ross International they prepared a simplified profit and loss account and balance sheet and asked practising accountants in each country to incorporate various transactions into an individual and consolidated set of accounts.

Advantages of administered questionnaires.

An advantage of the method was that given the same artificial data on which to make the same decisions, the outcomes could be compared directly, the one with the other.

Disadvantages of administered questionnaires.

As the task takes considerable time and needs a personal approach to the participants, the resulting sample is small.

3.2.1.10. QUESTIONNAIRES.

Although Roberts et al (1996, p.7) felt that the 'most obvious way to gather information on corporate accounting practices is... by looking at corporate annual reports', there is often little information on the main accounting policies. This can be overcome by the use of a questionnaire, which can be pre-tested before the main distribution. As it asks for opinions there is a duty to ensure that the replies are reliable. This is done by testing that the replies are consistent and if there are differences then they are not too great.

As a data source the use of questionnaires for specific research is important. This can be seen in Taylor, Evans and Joy (1986) who investigated the impact that five early IASs had on the comparability and consistency of reporting practices in 33 countries. Using questionnaires they asked two of the 'Big 8' accountancy firms in 40 countries to evaluate these effects on accounting reporting practices.

As this was a highly subjective area and the evaluation required expert judgement the questionnaires were completed by 'accounting executives who have been in public accounting long enough to be able to compare personally the state of accounting reporting before and subsequent to the issuance of IASC standards' (p.3). Of the 74 questions posted, 40 (54%) were returned which represented 33 (82.5%) countries. The final analysis in the study was limited to one response per country to prevent bias.

Gokarn (1984) used a similar method when he investigated the need for international accounting harmonisation. He obtained his data through a survey questionnaire of the partners of nine major accounting firms in 62 countries.

Doupnik and Taylor (1985) and Doupnik (1987) also used questionnaires in combination with PW surveys. In Doupnik (1987), questionnaires were sent to PW partners in the 46 countries included in the 1975 survey. They were asked to indicate the extent that accounting practices were used in his/her country (using a 5-point Likert scale). Responses ranged from 'required' to 'not permitted'. In all, the researcher received replies from 36 countries. From this information a data base with a common set of 70 financial reporting practices was set up for the 36 countries at two points in time - 1975 and 1983.

Advantages of questionnaires.

Considerable detail can be obtained by asking the right questions. Although it is important that the replies are reliable, the testing of such takes far less time than the compilation of information from other sources.

Disadvantages of questionnaires.

Consistency in answering must be maintained and reliability of information ensured. As the responses to the questionnaire depends on the knowledge and experience of the respondents it is also important to ask for information on their experience.

3.2.1.11. PUBLISHED FINANCIAL REPORTS.

In the current works under review, there are differences in the measurement methods, disclosure practices and auditing standards and practices. The fact that there are major variations in financial accounting practices in different countries can be observed or demonstrated in a number of different ways.

Blake (1990, p.28) has suggested four approaches:

- By dipping into any survey of comparative international practices;
- by classifying national accounting practices into different categories;
- by taking a number of broader factors for a sample of countries and focusing on public company practices (as per Nobes, 1983a); and
- by undertaking comparisons of company accounts in several different countries and observing the adjustments needed to obtain comparability.

‘Whichever approach we take, there are clearly extensive differences between accounting practices in different countries.’

A number of researchers whose work is dealt with in this review have made use of published reports. Their work covers not only measurement studies but also quantitative impact studies and classification studies. To gauge the extent of the samples, Table 3.6 below gives details in so far as France, Germany and UK are concerned:

Table 3.6 Use of Published Financial Statements by Researchers

Researcher(s)	Number of annual reports used in:		
	France	Germany	UK
Evans and Taylor (1982)	9	10	10
Weetman and Gray (1991)	-	-	41
Emenyonu and Gray (1992)	26	26	26
Joos and Lang (1994)	228	172	675
Archer, Delvaille and McLeay (1995)	12	22	18
Herrmann and Thomas (1995)	30	30	30

Nobes (1983a) added to his earlier work¹⁹ directed at classifying countries according to the financial reporting practices of public companies. He believed that the data of public companies should be the target data since it is the measurement and valuation practices used by those entities that is of interest to shareholders, creditors, tax authorities and other users.

Evans and Taylor (1982) in their harmonisation measurement study of compliance with IASs examined a sample of large company's annual reports from 1975-1980 in each of five countries. Van der Tas (1992a) considered that the work of Evans and Taylor (1982) was not a measure of harmonisation because the accounting standards may leave options open.

Nobes (1987) used random samples of 1985 published accounts to examine the degree of compliance with certain IASs. The work was criticised by Tay and Parker (1990, p.81) as containing too much 'emphasis on compliance with very narrowly defined IAS requirements.'

¹⁹ Nobes (1980) proposed a hypothetical classification scheme, which was based on measurement practices as well as the importance of laws and economics. It was this scheme that was used as the basis for this article.

As such 'the result does not reflect general standardisation of accounting practice so much as uniformity of compliance with these IAS requirements.' Joos and Lang (1994) also considered that the descriptions of principles of Nobes (1987) did not quantify the effects of the differences in accounting measurement practices because of the limited detail in the data.

Van der Tas (1992a) used 154 companies in Europe over a 10-year period (1978-88). Joos and Lang (1994) considered that the survey of national practices of van der Tas did not quantify the effects of the differences in accounting measurement practices because of the limited detail in the data.

Emenyonu and Gray (1992) reviewed accounting measurement practices of companies in France, Germany and the UK based on their 1989 annual reports. Only companies with turnover in excess of 1 billion were initially used resulting in 69 French, 77 German and 120 UK companies and from these 26 were randomly selected.

The sample chosen was to guard against any bias, but with some industries not represented, this could be a limitation. The authors also stated that the number of companies was limited by time and resource constraints.

The work was criticised by Joos and Lang (1994, p.143), who said that 'They do not attempt to evaluate the magnitude of the effects of measurement practices on the resulting accounting data or to assess the impact of factors, like hidden reserves in Germany, which are not detectable from footnote disclosures.'

Joos and Lang (1994) criticise Emenyonu and Gray on their work as it only covered one year and only made use of information from large companies. They argued that it was not possible to show the direction of harmonisation under these conditions. In their work Joos and Lang (1994) seek to overcome this deficiency in their sample of 172 German, 228 French and 675 UK companies preparing consolidated accounts over a period from 1982 to 1990.

Archer, Delvaile and McLeay (1995) used the 1990 accounts of selected companies in eight European countries whose shares were traded internationally and were therefore likely to be influenced by international factors and country-specific factors in the selection of accounting methods. The companies used were the same as used in Archer et al (1989) where 1986 data was used.

Herrmann and Thomas (1995) used data from 1992/3 to examine measurement practices. The authors wrote to 65 of the largest companies in each of ten EU countries (out of twelve at the time). The sample was based on the use of 'Europe's 15000 largest companies- 1992' but excluded financial institutions and insurance companies. As Greece and Luxembourg did not have large enough companies they were excluded and later Italy and Spain were eliminated as the authors received less than ten replies from each of those countries.

The authors justified their use of the largest companies as they felt that accounting harmonisation was an important issue for large multinationals. Large firms were more likely to be listed on foreign stock exchanges and so attract the interest of international investors. They also felt that there was a better likelihood of a response. They used English versions of the annual reports but translated six reports received from Belgium and eleven received from Portugal. Where both English and the domestic language report were received, no differences were found for the six measurement practices examined.

In the quantitative impact study by Weetman and Gray (1990) they attempted to determine the differences between UK and US reporting of profits. To do this they analysed the contents of Form 20-F for 37 UK companies that were required to file under SEC rules. In a later work (Weetman and Gray, 1991), where Sweden and the Netherlands were added, the authors used published accounts of 41 UK companies which traded on US stock exchanges, for their analysis.

Disadvantages of financial statements.

Although there are advantages of using raw data, the use of published financial reports are not without their problems. The collection of financial statements and

the assembly and collation of the data from them is not an easy exercise and is extremely time consuming. With the need to write or phone and a further need for follow up to request the financial statements, the cost of this data is far greater than using data from other sources such as surveys.

The translation of the financial statements is an additional problem. The reasons for this are:

- Translations may not be available in English. The reports are often in the domestic language which the researcher is not able to read or which requires an expert translator.
- If there is an English translation it may be a 'convenience' translation (Archer et al, 1989) which is '... not translations but reports written to meet what are perceived to be international standards.' These translations may reflect different reporting practices between translations. The data may be either incomplete or presented in a different form from the original statements. This limitation was noted by Herrmann and Thomas (1995) who noted that the majority of the reports are in English and although comparison between English and domestic languages reveal no significant differences, there could be a distinction.

The delay in obtaining the financial statements can result in time lags but this is often less than using data from, for example, surveys, where they are more out-of-date.

Where the sample used is of the largest companies it may not reflect the accounting practices of small and medium sized companies. This was a limitation noted by Herrmann and Thomas (1995) where they considered that the largest companies might not reflect the accounting practices of small and medium sized companies.

Advantages of financial statements.

Data can be up-to-date with current accounting practices if the current financial statements are used in the research. This depends on the work undertaken by the researcher and not on the availability of data from, for example, a survey.

Where particular information is required the researcher can extrapolate this from the financial statements and no 'guess work' is required by the researcher on the probable answer.

3.2.2. CONCLUSION ON USE OF DATA.

The selection of the data used in any study must be appropriate. Although the use of data from published information is much more time consuming, it is considered that the access to current information is critical to the thesis and this highlights the very point of this work. Financial accounting is rarely stagnant in any country and therefore it is not possible to rely on surveys or other data, which by their very nature are not up-to-date.

Taking into account all the criticism on surveys and the fact that there are no surveys currently available, which contain updated analysis of accounting practices, surveys have not been used in the thesis. In any event little purpose would be served in identifying the problems as the surveys themselves are subject to the many limitations described earlier. Instead use has been made of annual reports as the source of data.

Consideration has been given when taking companies from The Times Top 500 list. In so doing allowance has been made for those companies that fall both within and outside the CAC 40, Dax index or FTSE 100. Accounting harmonisation is important in the case of large multinationals that are more likely to have multiple listings and international investors. Accepting the fact that research using non-listed companies may produce different results, the problem is one of securing access to their financial statements. By using the larger companies there is a better likelihood of a response.

To overcome the criticism on convenience translations (Archer et al, 1989), translations were made and where necessary assistance in translation was sort. Comparisons between the translations and the English version (where available) were made as a form of verification on the accuracy of the translations.

There has also been comment on the small sample sizes used by previous researchers. One such comment was by Douppnik (1987) in reviewing the research by Evans and Taylor (1982). The author says that their conclusion that the IASC had little impact on accounting practices is suspect because one cannot generalise for a country as a whole based on the information of 10 firms. This limitation in research has also been taken into account in selecting the sample chosen. The limitations imposed on data collection and the choice of data, companies surveyed and other specific details are contained in Chapter 2.

3.3. INTERNATIONAL RESEARCH STUDIES.

In examining empirical research studies these can be divided into a number of specific areas:

- Classification studies (Nobes and Nair and Frank) which are attempts to place countries in clusters based on similarities or differences in accounting principles and practices;
- measurement studies (Van der Tas and Emenyonu and Gray) which try and measure the actual level of harmony in reporting practices of companies based on the reported measurement policies of companies;
- quantitative impact studies (Weetman and Gray, 1990/91) where the researcher tries to ascertain in money terms the impact of different accounting policies on reported figures of companies, and
- behavioural effect studies (Choi and Levich, 1991) which ascertain if and to what extent international accounting differences influence the actions of key players.

In examining the literature for this thesis, data sources under various classification studies (Da Costa et al, 1978, Frank, 1979, Nair and Frank, 1980 and Nobes, 1983a) were examined together with quantitative impact studies (Weetman and Gray, 1991). As the literature on behavioural effect studies is not relevant to the

thesis the remainder of the examination is limited to the area of measurement studies, which has been subdivided into international and European.

3.3.1. INTERNATIONAL HARMONISATION MEASUREMENT STUDIES.

Nair and Frank (1981) in their work set out to assess the impact of the IASCs harmonisation attempts made during the 1970s. The authors considered that there was sufficient elapsed time and enough empirical data for such an assessment. Van der Tas (1988 and 1992a) criticised Nair and Frank (1981) because the methods used were non- - parametric. He considered that this method of measuring harmonisation has no direct relationship with comparability, which is one of the main purposes of material harmonisation. He concluded (1992a) that the method was not appropriate to measure either de jure measurement harmonisation or de jure disclosure harmonisation

This study was followed by Evans and Taylor (1982, p.117) who regarded the IASC as 'the premier international body' and assumed that nations must follow IASC standards for harmonisation to proceed. They considered the IASC as 'the only body issuing statements with a global, rather than a regional orientation' and that it had 'raised most of the important questions regarding international accounting standards.' The research studied the effects of five of the earlier IASC standards on financial reporting practices in France, Germany, the UK, Japan and US. The authors were of the opinion that the lack of international accounting standards greatly diminished the usefulness of the financial statements to the users.

This was contradicted by Taylor et al (1986) who stated that the IASC appears to be improving comparability and consistency of the accounting reports and reducing the diversity of accounting practices.

Doupnik (1987) examined 70 financial reporting practices of 36 countries over two points in time - 1975 and 1983. The countries were grouped according to their degrees of commonality and their stability during the time periods was examined. He examined the extent of the harmonisation incurred since the establishment of the IASC in 1973 and also questioned whether the quality of international financial

reporting had improved. He considered that the answers could be determined by measuring the extent of compliance with IASC standards.

Nobes (1987) sought to test the hypothesis that US and UK companies do not follow international standards. He did this by examining various international accounting standards. He found differences of content or timing between national standards and international standards through the use of percentage compliance rates. His conclusion was questioned by Douplik and Taylor (1985) and also criticised by Tay and Parker (1990). Van der Tas (1992a) reiterated his opinion given on the Evans and Taylor work and did not consider that the Nobes (1987) study was a measure of harmonisation because the standards may leave options open.

This was followed by Nobes (1990a) examining the de facto effects of direct compliance with IASC standards on listed US corporations. He commented on the way in which IASC effects on companies were separated out rather than a look at changes to domestic standards. He concluded (p.49) that 'the evidence does not suggest that the IASC has no influence or importance, but that one would have to look elsewhere than at direct compliance by US corporations.'

In Rahman, Perera and Ganeshanandam (1996) the authors make use of an analysis of formal harmony between Australia and New Zealand by a comparison of all accounting requirements applicable to listed companies. These two countries were chosen because they have similar accounting regulatory environments and they are members of the same country cluster. It was considered that this will 'allow the results of the comparisons to be meaningfully interpreted' (p.328) as similar requirements mean greater harmony. But if the regulatory systems were different similar requirements would not mean that material harmony is high. The authors used statistical-empirical comparison between the measurement and disclosure requirements, which allows for the identification of accounting areas where formal disharmony exists.

3.3.2. EUROPEAN HARMONISATION MEASUREMENT STUDIES.

Turley (1983) attempted to evaluate the contribution of the 4th Directive to harmonisation of accounting in the EU. Diversity of accounting practice in the EU requires harmonisation because it may be 'prejudicial to the fusion of national market into a common market' (p.14) and it is also necessary to establish minimum equivalent legal requirements regarding the extent of publicly available financial information.

The study stated that it was not possible to separate different aspects of harmonisation and therefore it is not only harmonisation of format and content, but also of principles of accounting to be applied, and the objectives of producing accounts and their users and purpose that need be examined.

In reaching a conclusion the author stated that differences in accounting practices among countries are, to a large extent, indicative of more fundamental conceptual differences regarding accounting reports and that the 4th Directive did not result in complete harmonisation. Harmonisation 'requires more than a 'simple standardisation of disclosure requirements' (p.26). The author concluded that there was a need to address the objectives of the accounts and the specification of accounting principles. There is a need for more explicit consideration of the different socio-economic environments of EU member states.

Douppnik and Taylor (1985, p.27) in their study attempted to assess the extent to which 16 European countries conformed to a 'basic core of accounting practice' and examined the 'change in the level of conformity over time'.

They considered that as Europe is highly developed economically and in terms of the accounting environment, it could allow each country to develop its own accounting standard setting and therefore less obliged to conform to international standards.

Douppnik and Taylor (1985) faced criticism of their work in that they relied on the PW survey and a response from their own questionnaire modelled on the PW one.

In doing so they failed to acknowledge the shortcomings of the PW survey. The work also suffered from a lack of definition of the meaning of 'compliance with IASC standards.' Did this mean its adoption by the accounting bodies, its promulgation into law, or its observance by companies in the various countries?

Nobes (1990a, p.41) criticises Doupnik and Taylor for their confusion between de jure and de facto practices and also for their use of doubtful data. This was a follow up to his criticism in 1987 where he considered that the PW survey data was both subjective in nature and not intended for the purpose. He echoed past comment where the PW data was shown to be unreliable and unsuitable for classification purposes.

Nobes (1987) highlighted what he considered as inaccuracies by commenting on the measurement scheme, which produced misleading results in France and Jersey. He argued (p.78) that in France 'full compliance' of 1979 is a total fiction because in the year the data were drawn 'French law, French standards and French companies did not fully comply with IASC standards.' He observed that only about half the listed companies in France prepared consolidated accounts in 1979. As such he concluded that if there were clear-cut errors for France and Jersey, it suggested that there were many more with other countries.

Weetman and Gray (1991) follow on from an earlier study (1990) and explore the extent of the quantitative differences in profits reported under US GAAP to profit under GAAP in UK, Sweden and the Netherlands. The Netherlands and Sweden were chosen because, in classifying financial reporting measurement practices, Nobes (1989) positions Sweden and Netherlands at two extremes of a classification structure. While the Netherlands is micro-based, (influenced by business economics theory), Sweden is macro-uniform, (influenced by the government as an economic planner and tax collector). The UK and US are closer to the Netherlands than Sweden as they are also micro-based, although classed as being influenced by business practice and pragmatism.

Walton (1992) in his study hypothesises that if the EU's harmonisation efforts were successful, then each member state would produce broadly similar accounts having identical assets and trading activities.

The study tests accounting measurement practices in the UK and France and whether the application of GAAP is uniform. It is argued by the author that harmonisation of financial statements are of little use if measurement rules are not harmonised. The conclusion is that there is little uniformity or close consensus amongst either British or French accountants and there is some support for the notion that the French net profit measurement is usually more conservative than the British. Walton (1992) faced criticism from Joos and Lang (1994) on the use of the data.

Van der Tas (1992a) in his work measures the degree of harmony of the deferred tax policies in order to ascertain the extent of harmonisation during a given period and the impact of the EC efforts.

Emenyonu and Gray (1992) in their study attempt to assess the extent to which selected accounting measurement practices in France, Germany and the UK are harmonised in the EU by examining asset and profit measurement practices. They then attempt to quantify the overall extent of international accounting uniformity or harmony across the three countries. In the study they use data from the financial statements of 26 large companies.

Weetman et al (1993) compare the profits measured under UK and US GAAP and the reasons for the lack of comparability e.g. goodwill, deferred tax, etc. Differences in reported profit and equity were compared to a benchmark or 'index of conservatism developed in previous research work by the authors.'

Joos and Lang (1994) investigated the effects of the differences in accounting measurement practices in financial statements of France, Germany and UK. 'The differences across countries appear largely unaffected by ... Directives, which were intended to create an integrated set of reporting standards...' (p.141).

Archer et al (1995) examined the accounting policy choices made by companies in eight countries in Europe (Belgium, France, Germany, Ireland, the Netherlands, Sweden, Switzerland and UK). The companies were chosen as likely to be influenced by international factors and country-specific factors in the selection of accounting methods.

They considered that measurement has a challenging methodology and that comparability of an item presupposes disclosure (disclosure harmony). Comparability further depends on similarity of accounting recognition and valuation rules (measurement harmony). The comparison is subjective - how close is the similarity of accounting methods to be comparable?

They conclude that the C index has restrictions in measuring harmony and that it is insensitive to interactions between intra-national and inter-national trends. As a result the authors decompose the index.

Herrmann and Thomas (1995) build on the work of Emenyonu and Gray (1992). They studied the level of harmonisation in the EU by examining selected measurement practices²⁰ (as opposed to disclosure practices) from 1992/3 annual reports of companies in Belgium, Denmark, France, Germany, Ireland, the Netherlands, Portugal and the UK.²¹ Harmonisation of accounting practices is thought to be a major means of achieving a single common market. Although cultures are quite distinct many member states are major industrialised countries with well-established capital markets.

3.4. DEFINITIONS.

There has been a tendency for writers to use the terms 'harmonisation' and 'standardisation' as if they were synonymous (Tay and Parker, 1990). In preparing this thesis it is important that the fundamental definitions be fully covered and that

²⁰ Selected practices are: foreign currency translation of assets and liabilities, treatment of translation differences, stock valuation (it is shown that they are harmonised); fixed asset valuation, depreciation, goodwill, research and development costs, stock costing and foreign currency translation of revenues and expenses (the results show that they are not harmonised).

the work of previous researchers who attempted to highlight the differences in the meaning of the two words, be examined to help in this regard. A great deal of writing has taken place in an attempt to define what harmonisation is about. Within the literature there is some confusion as to the meaning of the two terms and in many of the harmonisation studies the terms have been used almost interchangeably.

Nair and Frank (1981) define harmonisation and state that 'to harmonise accounting standards is to bring them into agreement' (p.68). This definition was criticised by Tay and Parker (p.76) who say that what Nair and Frank are actually doing is to define harmonisation in terms which really define standardisation. This was endorsed by Emenyonu and Gray (1992) who defined standardisation as meaning 'that a single standard or rule is applied to all situations'.

Choi and Mueller (1984, p.470) stated that harmonisation means that '...different standards might prevail in individual countries, so long as they are 'in harmony' with each other - meaning they should not logically conflict.' They also stated that standardisation 'means that a single standard or rule is applied to all situations.'

Other attempts at defining harmonisation were made by Evans and Taylor (1982) and Doupnik and Taylor (1985) who Tay and Parker (1990, p.71) considered were using harmonisation and standardisation as if they were synonymous. Tay and Parker said that their empirical research together with Nair and Frank (1981) lacked conceptual clarity and had shortcomings in the data sources used.

Turley (1983) in his paper examined the meaning of harmonisation and using the definition of 'a consistent or orderly whole'²² concluded that this implied that legislation for harmonisation is 'concerned with removing inconsistencies' (p.15). This was endorsed by Doupnik (1987) who defined harmonisation as the process by which differences in financial reporting practices are reduced.

²¹ The countries were selected because they are all members of the EU.
²² Concise Oxford Dictionary.

Tay and Parker (1990, p.71) differentiated between 'harmonisation' and 'standardisation'. Their research had as one of its aims 'to discuss the problems involved in the measurement of the concepts of harmonisation and standardisation.' In order to achieve this they suggested a clarification of the distinction between these terms and the related concepts of 'harmony' and 'uniformity'.

They regarded harmonisation (a process) as a movement away from total diversity. The process was trying to increase the compatibility between two or more subjects by narrowing the differences between them, while standardisation (also a process) involved 'a movement towards uniformity'. Harmony (a state) reflects the degree of compatibility that exists between two or more subjects at one particular point of time.

In a later work, Herrmann and Thomas (1995, p.254) define harmonisation, acknowledging that it is not simple and they point out that the definition has varied in prior research. In this paper they consider two aspects:

- Harmonisation is the similarity in the frequency of accounting policy choices across countries. That is, harmonisation is achieved when the companies in each country select accounting policies with the same frequency. [To measure this de facto harmonisation, the chi-square test of independence is used.]
- Harmonisation is the extent of concentration around a particular accounting policy choice. This increases as the number of companies selecting the same accounting policy increases. [This type of de facto harmonisation is measured using a concentration index developed by van der Tas (1988).]

Tay and Parker questioned if, in fact, Herrmann and Thomas were measuring de facto harmony.

Harmonisation and standardisation may appear dichotomous but this is superficial. Both harmonisation and standardisation are processes, the difference being that whereas harmonisation aims at moving financial statements away from total diversity of practice towards harmony, standardisation attempts to move them

towards uniformity. It is not always easy to determine at what point on the continuum an accounting regulatory process changes from harmonisation to standardisation.

The continuum has total diversity and rigid uniformity as the two extremes. Harmonisation is any point between total diversity of accounting practice and rigid uniformity.

'Uniformity' is the most difficult to define in precise terms. In the US it was often used to imply the setting of rules and guidelines for application in the preparation of financial statements. This was in contrast to the practice at the time of leaving preparers of accounts the right to determine methods of accounting. Uniformity became linked with the idea of a 'restrictive codification of do's and don'ts' (Tippit, 1963, p.78). This could mean a uniform chart of accounts (such as exists in France). This shows the inflexibility of such a system.

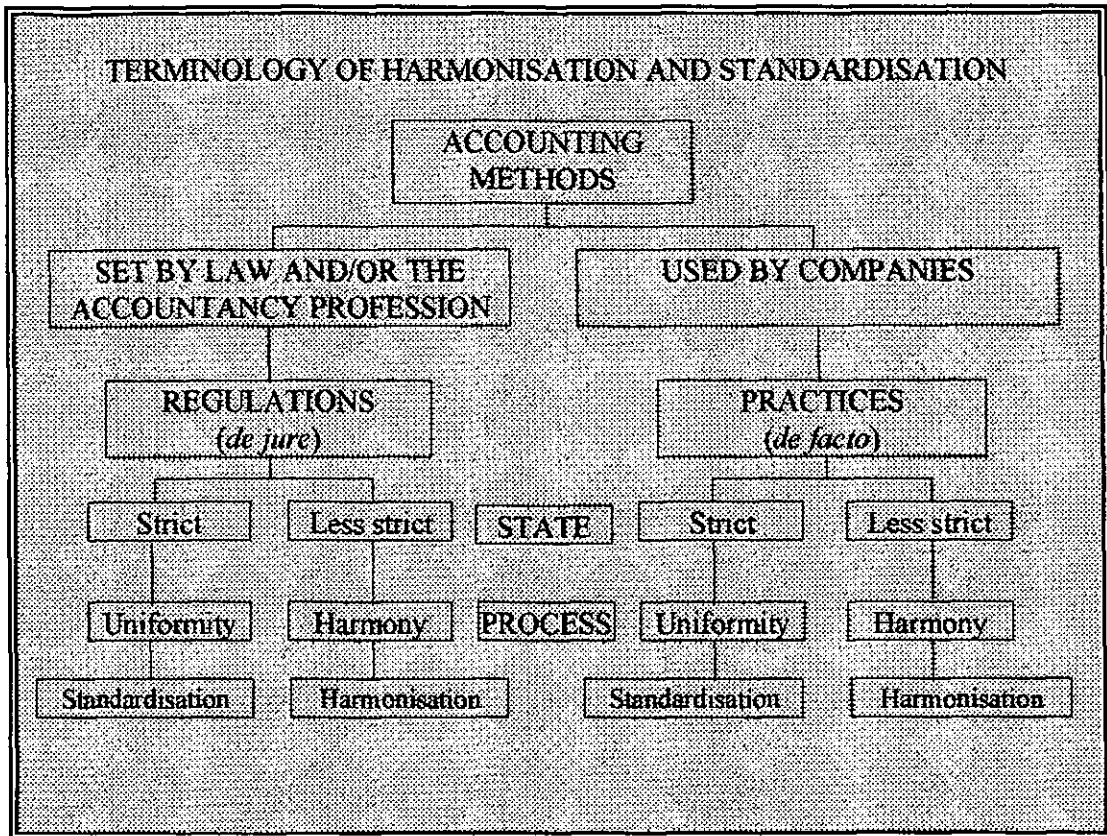
Another notion of uniformity is to treat like transactions in the same way although this is less acceptable today, where conventional usage tends to describe uniformity as the rigid compliance to some set of rules (Tay and Parker, 1990, p.73).

Harmony and/or uniformity can arise 'de jure' brought about by accounting regulations. This is through the strict compliance with Companies Acts or a less strict compliance with accounting standards.

Harmony and/or uniformity can arise 'de facto' brought about by actual accounting practices adopted by companies. Where this is applicable to all companies this would be strict compliance while if only applicable to a few companies it is classed as less strict. Where there is a move in accounting regulations and practices towards strict compliance it is associated with uniformity and where it is less strict it is associated with harmony.

Having drawn the distinction between harmonisation, harmony, standardisation and uniformity Tay and Parker then subdivide these issues between strict and less strict regulation, resulting in eight concepts being identified (see Fig 1).

Figure 1 Harmonisation and Standardisation



Source: Tay and Parker, (1990,p.74).

In a later paper van der Tas (1992a) agrees with Tay and Parker on de jure and de facto concepts and that harmony and uniformity are states and that harmonisation is a process. He does, however, comment on their work as it relates to the examination of IASs. Tay and Parker (1992) in their reply to van der Tas (1992a) point out that they recognise the differences between compliance with IASC standards and accounting harmonisation. This resulted in the distinction between de jure and de facto harmonisation. ‘The measurement of de jure harmonisation does not appear to us a very useful exercise in itself, if the ultimate concern of harmonisation is to increase the comparability of financial reporting’ (p.218). De facto harmony would help indicate a closeness of the link between de jure and de facto harmonisation.

Taylor, Evans and Joy (1986) defined comparability and consistency and Walton (1992) extends the definition of EC harmonisation to create a clustering of practices.

According to this latter study there are three primary questions in the area of accounting harmonisation. These are:

1. Is there a need for harmonised practices?
2. What factors are most favourable and most obstructive to the process?
3. To what extent are current accounting practices harmonised?

Subjects (in accounting) can either be financial reporting practices of companies or financial reporting standards. Van der Tas (1988) set out to quantify harmony; to determine when and to what extent harmonisation had taken place; and to measure the impact on international harmonisation by the organisations involved. He did this by suggesting two main statistical approaches to quantify these concepts. These involved the use of the I index and the C index.

Material (de facto) harmonisation refers to the harmony of financial reporting practices and a study to investigate this concept would involve an examination of annual reports. Formal (de jure) harmonisation refers to the harmony of financial reporting standards and a study of this would require an examination of reporting standards, regulations or guidelines.

Material or formal harmonisation can focus on the harmony of measurement issues (valuation, estimation, and recognition) or the harmony of disclosure issues (extent and detail of information provided). This thesis is focused on a review of actual measurement practices of companies (groups) as reflected in the annual reports (material measurement harmonisation) rather than on accounting standards (formal harmonisation). By its very nature, however, the thesis also examines the formal harmonisation within the three selected countries.

The definition offered by van der Tas (1988, p.158) is that 'Material measurement harmonisation is an increase in the degree of comparability and means that more companies in the same circumstances apply the same accounting method to an event or give additional information in such a way that the financial reports of more companies can be made comparable.'

While standardisation is a uniform standard in all countries that participate, harmonisation is 'a reconciliation of different points of view and permits different requirements in individual countries as long as there is no logical conflict' (Meek and Saudagaran, 1990, p.169).

3.5. INDICES AND STATISTICAL METHODS.

In examining the methods used to measure accounting harmonisation it is important to note that the harmonisation indices used in studies are suitable for measuring the degree of harmony on an item-by-item basis rather than on providing information on the comparability of financial statements on an aggregate basis. While some studies have examined the degree of harmony for a number of disparate measurement issues (Emenyonu and Gray 1992 and Herrmann and Thomas, 1995), others (Van der Tas, 1988, 1992a and Archer et al., 1995) have concentrated on measuring material measurement harmony for only one or two measurement practices.

Although outside the scope of a qualitative analysis study, it is important to review the various statistical tools of analysis that have been used by researchers in the determination of harmonisation by countries.

Initially researchers used various methods ranging from empirical testing of country models (Da Costa et al, 1978 and Walton, 1992), through factor analysis by Nair and Frank²³ (1980) and Doupnik (1987) to Friedman's Analysis of Variance²⁴

²³ Nair and Frank (1980) classified both accounting measurement principles and disclosure practices using factor analysis. Using discriminant analysis, the environmental variables were determined for each set of groupings.

²⁴ Siegel (1956).

by Nair and Frank (1981, p.69).²⁵ The latter has been criticised by Tay and Parker (1990) who felt its use was not appropriate. They also raised doubts about the data sources and the operational definition of harmonisation. Subsequently (1991) they stated that when using this method of testing 'the concept must be properly defined and operationalised, and data properly interpreted and appropriately categorised.' '...a number of other alternative methods are applied and/or permitted. ... which means that financial reports are hardly comparable.'

Other researchers presented percentage compliance rates (Evans and Taylor, 1982) or used weighted averages scores for each country (Doupnik and Taylor, 1985)²⁶ or an index of conservatism (Weetman and Gray, 1991).

The Evans and Taylor (1982) conclusion was criticised by Doupnik (1987) as suspect because the information of ten firms cannot be used to make a general assertion for a country. Doupnik stated that the authors used a small sample and did not separate out the IASs direct effects on companies as opposed to effects through changes to domestic standards. Further criticism was levied by Herrmann and Thomas who stated that accounting measurement and disclosure issues were combined while Tay and Parker said that the definition of harmonisation was really a definition of standardisation.

Tay and Parker (1990, p.80) contended that the use of weights by Doupnik and Taylor (1985) implied that some quantifiable relationship existed among the response categories while Nobes (1987) said that discussions of increases and decreases in country scores had little relationship to reality. In his view the 'conclusions [of Doupnik and Taylor, 1985] were not credible' (p.78).

²⁵ Harmonisation on any practice was considered to have taken place if more than half of the 37 countries were found on the extreme positions of 'Required' or 'Not permitted'. Through the movement from one practice to another the authors were able to show evidence of increasing harmonisation as 49 practices were identified for 1979 of which 39 were in the 'Required' group, while 10 were at the other end in the 'Not permitted' category. To aid comparability Nair and Frank tested the statistical significance of changes in the five sections by using Friedman's Analysis of Variance.

²⁶ The range was from 0.00 if all propositions were in the category of 'not permitted' to 4.00 if all were categorised as 'required'. The larger the score, the greater was the level of compliance with IASC standards.

McKinnon and Janell (1984) used a descriptive analysis of accounting regulations of IASC members in their research. They examined the influence of the IASC on the ASC (now known as the ASB) and FASB statements on foreign exchange translations. The study analysed the role of the IASC through an analysis of three accounting issues; depreciation, equity method of accounting and foreign currency translation. '...few have questioned the desirability of harmonised standards. Most opponents have focused on the practical difficulties of achieving agreements among different countries...' (p.20).

Taylor et al (1986) grouped 33 countries into cultural classifications (Anglo-American, European and other). An analysis of variance results indicated that the extent of the improvement did not differ significantly across these cultural groups when 'culture' was defined as the broad geographical groupings.

Van der Tas (1988) introduced the idea of indices. Three indices of concentration measurement were developed and adapted in order to quantify the concepts of harmony and harmonisation:

- the basic Herfindahl index (H-index) which measures the concentration or frequency with which one or a limited number of alternative methods occur,²⁷
- the C index to measure the degree of harmony within a national context,²⁸ and
- the I index to express the degree of international harmonisation measurement.²⁹

He demonstrated the use of these indices by measuring levels of harmonisation of deferred tax in the UK, various aspects of investment tax credits in the Netherlands and US, and the valuation of land and buildings in the Netherlands. He drew attention to one limitation, which was how to measure the significance of changes in the indices involved.

²⁷ The problem is to cope with multiple reporting or additional data in the notes.

²⁸ The C index gives an expression of the degree of harmonisation or comparability based on all possible pairings of the companies examined.

²⁹ The I index multiplies the relative frequency of the application of a specified alternative in one country by the relative frequency of the application of the same alternative in a second country and adds the results.

Van der Tas maintains that it is possible to quantify the degree of harmony and harmonisation of financial reporting. He asserts that it is possible to measure the influences of mandatory and non-mandatory provisions relating to financial reporting. The applied method satisfies a number of criteria, a major one being that its quantification of the degree of harmony is directly related to measuring comparability between published accounts.

Tay and Parker (1990) found that the van der Tas (1988) approach of using concentration indices to measure harmony had potential but felt that the lack of statistical testing was a shortcoming. Various problems including those associated with data sources (what sources should be used - national/international surveys or original financial statements) and the various statistical methods employed in the determination of measurement, (descriptive statistics, non-parametric statistics and indices) are examined. Other areas of concern which were examined by the authors were the methods used for the determination of reasons for changes in accounting practice (be it the compliance with standards or other reason), and operationalisation of concepts.

Tay and Parker (1990) suggested a study focused on the actual reporting practices by companies as disclosed in their annual reports rather than as stated by regulatory requirements, that is a *de facto* versus a *de jure* approach. Data from the reports could be subjected to statistical significance tests using chi-square tests and applying the indices suggested by van der Tas.

'If harmonisation activities are the result of concern about the comparability of accounts produced by companies from different countries, then a measurement study should focus on actual reporting practices (*de facto*) rather than regulations (*de jure*)... Actual reporting practices may be assessed most accurately from annual accounts, or detailed surveys of such accounts' (pp.84-85).

The authors concluded that the concepts involved have not been clearly defined and that none of the work studied measured *de facto* harmonisation.

Tay and Parker (1990) propose that the 'evidence of harmony' would then be the existence of a significant difference between the observed and expected distributions, as measured by some appropriate significance test, for example chi-square.'

The second point arising from the paper was that there are two useful measurement approaches:

- the use of concentration indices; and
- the use of non-parametric tests.

'Taking account of both the desirability of international comparability of financial statements, and the operational difficulties involved in measuring processes rather than states, the most suitable concept for measurement appears to be *de facto* harmonisation, in the form of studies of *de facto* harmony over time' (pp.74-75).

Weetman and Gray (1991) developed an index of conservatism to measure differences. They stated that the assessment was complex and there was a bias of accounting principles towards profits. With a small sample size it was not possible to do tests of statistical significance.

Van der Tas (1992c) built on his 1988 work and develops this work in part as a response to Tay and Parker. He examined deferred taxation of European companies for a 10-year period using 154 listed companies. In undertaking this he examined both the individual and consolidated accounts.

He uses the C index which attempts to overcome the problems of the H-index. The C index is able to take account of multiple reporting, including reconciling data in notes to the accounts and, through the application of regression analysis, it is possible to calculate the significance of movements in the degree of harmony over time (given enough data). The C index is measured by dividing the number of pairs of companies applying the same measurement method by the total number of pairs of companies in the population i.e. all companies applying any particular method.

It is not possible to develop one method of measuring both de jure harmony and de facto harmony. On the method used by Tay and Parker, he concludes that it is 'not better to measure de facto measurement harmony than the C index and may be worse' (p.215).

Van der Tas (1992b) sees that two main problems exist with the harmonisation index. There is no significance test to the significance of movements in index values over time and there is its inability to cope with multiple reporting methods, a common feature of, for example, goodwill accounting.

Emenyonu and Gray (1992) applied the approach of van der Tas and incorporated the Tay and Parker suggestions. They assessed the extent to which accounting measurement practices in France, Germany and UK are harmonised in the context of the EC harmonisation movement. Samples of annual reports of large companies, selected randomly so as to guard against any bias, were used together with the I-index complemented by chi-square tests to quantify and evaluate the level of international accounting harmony across the three countries. 'However, the fact that some industries were not represented in all of the country samples is recognised as a limitation' (p.51).

The authors concluded (p.56) that 'there are statistically significant differences in the measurement practices...' They state that these differences tend to confirm the view that the measurement provisions of the 4th Directive 'are inherently flexible'. They conclude (p.57) by saying that 'measuring the extent of harmony of accounting practices of companies internationally is still very much at an exploratory stage. ...there is substantial scope for further research which could cover a larger sample of companies and include additional ...practices such as deferred taxation, pensions... Group accounting and consolidation practices...' It is their view that the significant differences across countries are evidence of differences in accounting standards. They consider that the research paper has an additional aim namely 'to contribute to the development and application of quantitative measures of international harmonisation' (p.51).

One drawback of the study was that it covered one year only and did not provide any sense of direction in trend. The limitation of large industrial companies also meant that it was unsafe to extrapolate the findings to all types of companies.

Herrmann and Thomas (1995) built on the work of Emenyonu and Gray (1992) and examined the harmonisation of selected measurement practices in the EU. They used 217 companies to assess the degree of harmony in nine specific measurement practices.

The authors feel that earlier research falls short in:

- distinguishing between measurement and disclosure issues;
- data selection;
- statistical tests of significance; and
- measurement of harmonisation.

In their work they detail past studies which frequently combined accounting measurement and disclosure issues (Nair and Frank 1981, Evans and Taylor 1982, McKinnon and Jannell 1984). While the extent of harmonisation has been based on combined practices the authors agree that there is a need to distinguish between the two practices.³⁰ Past research by Evans and Taylor (1982) and McKinnon and Jannell (1984) has relied on descriptive statistics and researchers' interpretation as to the extent of harmonisation.

In this study the authors only looked at measurement issues. The data selection uses annual reports and the study tests de facto harmonisation in contrast to the majority of studies on de jure harmonisation. They cite the statement by Meek and Saudagaran (1990, p.147) that 'Examining only the required standards can result in a misleading picture of actual accounting practices in a country.'

³⁰ In this work Hussein (1992) found that measurement practices were harmonised but not disclosure practices.

In a review of measurement methods the authors show that a statistical test of significance is used by some authors Emenyonu and Gray (1992) while others, such as Evans and Taylor (1982), McKinnon and Janell (1984) and Douprik and Taylor (1985), relied on interpretations of means, percentages and ratios. Herrmann and Thomas state that differences in the level of harmonisation across countries will be tested for statistical significance with the non-parametric chi-square test of independence.

In a conclusion to this paper Herrmann and Thomas (1995, p.264) state that 'This paper develops modifications to the chi-square and I index to allow for small cell sizes and the 'zero effect'. Research measuring the extent of accounting harmonisation is still in an early stage of development.' The results also demonstrate that the extent of harmonisation is greater among 'fairness' oriented countries than among 'legalistic' countries.

Weetman et al (1993) using the index illustrated statistically that the differences in accounting practice (not performance) brought about by compliance with national standards led to the UK reporting higher profits than their US counterparts. They were also able to conclude, that of these differences, the 'amortisation of goodwill is the single most material item in the reconciliation of profits under UK practice with profits under US GAAP' (p.18).

Joos and Lang (1994) reported that a variety of measures to reflect the effects of accounting differences across countries are available from existing research. The paper evaluates the diversity in measurement practice based on divergence in accounting-based measures of profitability, the valuation multiple applied to accounting data, and the degree of association between accounting data and share price. The authors use three primary analyses to examine differences in measurement across countries (univariate ratio analysis, returns regressions, and price regressions).

Archer et al (1995) in their research, used the C index³¹ which they expanded by separating it into two components³² relating to the within-country (intra-national) effects of domestic standardisation and the between-country (inter-national) effects of harmonisation.³³ They used the resulting index to measure the degree of harmony in the treatment of goodwill and deferred taxation for a sample of European companies. The paper also considered the problem of non-disclosure and in so doing introduced a comprehensive 'disclosure-adjusted' comparability index. Previously if companies did not report on a specific item, or did not disclose the accounting method, they were excluded from the index.

The paper states that 'the measurement of accounting harmonisation raises some challenging issues of methodology' (p.72). Comparability of an item presupposes:

- disclosure of that item either in the financial statement or the notes (disclosure harmony);
- similarity of accounting recognition and valuation rules employed (measurement harmony).

The authors also identify in the paper the minimum level of the comparability index. They state that 'for any given numbers of companies and of different accounting methods for a particular financial statement item, the lowest level of comparability exists when the accounting methods are assumed to be distributed equiprobably over the companies, the outcome of a random selection' (p.67). Comparability increases when company choices converge towards a generally accepted method or when the number of accounting methods in use is reduced.

³¹ While the authors agree that the C index is a measure of comparability of financial statements on an item-by-item basis, their view is that it is not a measure of overall comparability. The C index has been used to measure comparability at national or global level while the I index has been used to measure inter-national comparability. The C index may be used to measure harmony of a sample of companies for single financial statement items.

³² Van der Tas (1988) calculated the separate I index.

³³ Previous research by van der Tas (1988) and Emenyonu and Gray (1992) distinguished between inter-national and intra-national comparability.

It is the authors' view that it is deficient because it is insensitive to the interactions between intra-national and inter-national trends in accounting policy choice and 'therefore is an imperfect measure of *international* harmonisation' (p.79).

Rahman Perera and Ganeshanandam (1996) explore the method of measuring formal (de jure) harmonisation between countries. The paper stresses that the methodology introduced can be used to identify areas of harmony or disharmony for policy-making purposes.

Because of the growing economic co-operation between countries at both global and regional level, greater attention is being paid to empirical evaluation of international accounting harmonisation. Tay and Parker differentiated between harmonisation and standardisation explaining that harmonisation meant clustering of accounting practice around a few available methods with a view to achieving harmony between accounting practices and standardisation meant strict adherence to one set of rules to achieve uniformity in practices. Van der Tas (1988 and 1992b) provided an alternative terminology for describing harmonisation. He called de jure, 'formal' and de facto, (irrespective of whether the practices were influenced by regulations or not), 'material harmonisation'.

Studies on the evaluation of accounting harmonisation have focused on investigating material (de facto) harmonisation or its effects, rather than researching formal (de jure) harmonisation. This is in spite of the fact that practically every study evaluating material harmonisation has measured the effects of the state of formal harmony on practice.³⁴

Therefore it is well recognised that 'a primary factor driving material harmonisation is formal harmonisation' (p.325). 'Accounting harmonisation studies are very much at an experimental stage where methodology and analytical techniques are still being proposed and tested on particular samples of accounting issues and countries' (p.326).

³⁴ Nair and Frank (1981), Evans and Taylor (1982), Doupnik and Taylor (1985) and Yang and Lee (1994) explore the effects of IASs; Emenyonu and Gray (1992), van der Tas (1992b) and Walton (1992) study the impact of the 4th Directive.

In this study the authors propose to demonstrate the use of a research design for evaluating the state of formal accounting harmonisation across countries. The research design demonstrates the application of empirical analysis to measure formal accounting harmony. To make the comparison exhaustive, disclosure and measurement requirements are matched separately. The authors draw attention to studies by Tay and Parker and van der Tas (C and I indices) and to the fact that the indices are used for measuring accounting harmonisation between countries. But they point out that this is for measuring de facto and not de jure harmonisation. To make an item-by-item comparison they use a statistical procedure - measurement by statistical-empirical comparison between measurement and disclosure requirements for Australian and New Zealand companies.

The methodology allows for identifying accounting areas where formal disharmony exists. It identifies the extent of uniformity and allows for discovering of possible material disharmony even with similar rules. It creates new grounds for examining various other aspects of accounting harmonisation.

All the methodologies are applied to measure accounting issues separately. This gives more refined results, as it is possible to measure the degree of material measurement harmony by individual transaction instead of an aggregate result based on measuring harmony of all events.

3.6. CONCLUSIONS OF PAST RESEARCH.

Evans and Taylor (1982) undertook a harmonisation measurement study of de facto uniformity by examining the degree of compliance with IASs. Little attempt was made to justify their choice of countries although they stated that 'all of these nations are founding members of the IASC' (p.120). In doing this they excluded four other founding members - Australia, Canada, Mexico and The Netherlands. Had these other four countries been included then the authors could have relied upon previous research by Mason (1978)³⁵ to justify their sample.

³⁵ Mason suggested that successful attempts at international harmonisation required the support of six 'vital countries' as stated above.

The results of the study were given as percentage compliance rates per country for each year and from these results the authors' conclusions were that 'the IASC has had very little impact on the accounting practices of the countries surveyed' (p.126). There was evidence that a country continued to follow a particular method even after the introduction of an IASC standard.

This finding was confirmed by McKinnon and Janell (1984) who concluded that the IASC did not influence countries but did identify and codify standard practice. There was no conclusion for foreign currency translation. They recognised the limitations of the PW survey and that it only covered depreciation practice two years after IAS 4 was introduced.

In a later work by Douppnik and Taylor (1985) the authors found that while Europe registered the lowest level of compliance with IASC standards, it did show the greatest percentage increase in mean score over the period 1979-1983, which may indicate that resistance to conformity is diminishing. In general the UK, Ireland, France and the Netherlands are in greatest conformity while 'German speaking countries and Southern European are in least conformity'(p.33).

The authors found that 'overall, the general conclusions are that Europe as a whole lags behind the rest of the world in achieving a 'lowest common denominator' level of accounting practice, and that such diversity continues to exist among the countries of Western Europe regarding conformity to a basic core of accounting practice' (p.33). 'European countries were more inclined to conform to propositions related to disclosure requirements than those related to measurement practices' (p.33).

Here as with other works (McKinnon and Janell 1984, Douppnik 1987), their findings need be treated with caution as they relied on the PW surveys (1979 survey) and the responses they obtained from a questionnaire modelled on that survey.

McKinnon (1985) states that 'the findings ...are disturbing in terms of the prospects for international accounting harmonisation. If internationalisation comes about

through enforced conformity rather than conceptual merit or appropriateness to anthropological and cultural characteristics, the resultant information system will be insufficient as well as inefficient.’

In Douppnik (1987) the results show a decrease in the differences in financial reporting and an improved quality on an international level although West Germany and Switzerland were exceptions. Douppnik concludes that there is evidence of harmonisation but there are also substantial differences among countries in a group and between groups. The author recognises various limitations in using PW data. There may be errors and certain terms may have different meanings in different environments. He criticises other work on the basis that it speculates as to the reasons for differences in accounting.

Another limitation is that the same individuals may not have responded to both the 1975 and 1983 surveys and that ‘differences over time may therefore be a result of the different perceptions of different respondents rather than actual changes in usage in a given country’ (p.63).

Van der Tas (1988) based his study on a survey of company reporting practices and provides a distinction when defining harmonisation (an example of de facto harmony). The work introduces the idea of using indices for measurement.

Tay and Parker (1990) review six studies³⁶ undertaken between 1981 and 1988 dealing with the measurement of international harmonisation of financial reporting. In the paper they do not attempt to examine studies, which deal with the extent of disclosure, as such studies, are, in the words of the authors, ‘ultimately concerned with the quality of information contained in company accounts’ (p.71). Their intent is to examine the similarity of accounting practices and regulations. (Harmonisation measurement studies).

After examining the six measurement studies, the authors are of the opinion that there has been no comprehensive measurement study of de facto harmonisation and

as such the evaluation of the work of the IASC and the EC in 'achieving greater comparability of financial statements produced by companies in different countries have been incomplete' (p.76).

Nobes (1990a) notes the distinctions between de jure and de facto harmonisation as discussed by Tay and Parker (1990) and also deals with Nair and Frank's (1981) look at de jure harmonisation between 1973-1979 and Evans and Taylor's (1982) paper which finds little de facto compliance with IASs.

In dealing with de jure harmonisation, McKinnon and Jannell (1984) conclude that the IASC has not succeeded in changing existing standards or setting new standards. In a subsequent work, Nobes (1990a) concluded that compliance with IASs was negligible.

In an earlier work Nobes (1985) seeks to define 'success' in the context of the work of the IASC.

Areas of difference between GAAP (which must be obeyed) and international standards are identified. Three areas, minority interests, depreciation and pooling, are chosen where there is no GAAP but IASs do exist. From the examination of these areas the author notes that the differential requirements of international accounting standards are not obeyed by most listed companies and IAS have no direct impact. Any compliance therefore is because of other factors e.g. pressure from auditors or users of financial statements.

Weetman and Gray (1990, p.111) measure the quantitative impact and 'explore the extent to which there are systematic differences between UK and US accounting principles likely to give rise to significant quantitative differences in earnings and assessments of comparative corporate performance.'

Weetman and Gray (1991) consider that little empirical work has been undertaken using published financial reports. In this work, using the index of conservatism, US

³⁶ The six studies were Nair and Frank (1981), Evans and Taylor(1982), McKinnon and Janell (1984), Doupnik and Taylor (1985), Nobes (1987) and van der Tas (1988). Of the studies above only the work by van der Tas falls into the de facto harmonisation category.

GAAP is used as the benchmark and the reported profits of the other countries are adjusted accordingly. For this purpose Form 20-F is used where companies reconcile their home reported profits to US GAAP.

The authors conclude that UK GAAP is significantly less conservative than US GAAP and that the Netherlands is similar to the UK. '...the overall quantitative impact of differences in accounting principles on profits in the US, UK, Sweden and the Netherlands is often significant...' (p.377).

Walton (1992) tests:

- whether accounting principles are applied relatively uniformly in each jurisdiction; and
- whether post-harmonisation, the application of generally accepted accounting principles in one jurisdiction leads to a financial report, which is comparable with that in another.

The conclusions were based on a very small sample.

Van der Tas (1992a) comments (p.74) on Evans and Taylor (1982), Doupnik and Taylor (1985) and Nobes (1987). In the author's view measuring compliance with or observance of international standards is not a measure of harmonisation. (A conflicting view was expressed by Tay and Parker). He gives an example in support: 'If compliance with international standards is high, this does not necessarily mean that the degree of harmony is high, because the standard may leave options, all of which are exercised by companies.' 'If compliance is low, the degree of harmony may be high if all companies apply the same method, not allowed by the standard' (p.74).

In his research he criticises Nair and Frank (1981) for their method and supports his own. He says that 'this method (i.e. nonparametric testing) of measuring harmonisation has no direct relationship with comparability, which is one of the main purposes of material harmonisation' (Van der Tas, 1992a, p.72).

He approached harmonisation from the point of view of the type of transaction or event (rather than compliance with international accounting standards) and used the analogy between concentration and harmony to apply methods of measuring concentration to a similar measure for harmony. When the H index is used to measure the level of harmony or harmonisation in accounting the relevant variables are:

- the number of accounting methods acceptable or used on the particular topic;
and
- the number of companies using each method.

Joos and Lang (1994) provide evidence from a capital markets' perspective, on how cross-country differences in measurement practices affect the comparability of the resulting accounting data. The authors also provide preliminary evidence on the effects of the EC Directives on accounting measurement differences but not on accounting issues and disclosures, which are not considered in the study (p.142).

The authors surveyed past research by Simmonds and Azières (1989) and Walton (1992) who assess measurement diversity by using financial statements constructed from hypothetical transactions. Both find evidence of measurement differences within and across countries but both are based on data prepared during the implementation of the directives and neither compares pre- and post-directive differences or conducts statistical tests.

The authors examine the variety of approaches used to determine the effectiveness in reducing accounting diversity. These include surveys of Nair and Frank (1981) and van der Tas (1988) and descriptions of accounting principles from footnote disclosures (Nobes 1987). In the view of the authors none of the above are useful in quantifying the effects of differences in accounting measurement practices on financial statements because of the limited detail available. The authors use 'a capital-markets-based approach which uses comparison of resulting differences in companies' profitabilities and price multiples across countries to infer the effects of measurement differences' (p.143).

No evidence could be found that differences were reduced following the implementation of the Directives. Substantial accounting differences existed and the Directives did little to reduce them. Unless the number of options is limited and the effects of tax-based and other incentives are reduced, the changes intended by the Directives may be limited.

Archer et al (1995) who analysed the accounting practices in order to measure the degree of harmony in 1986/7 and 1990/1 and therefore the process of harmonisation between those years, supported this. The purpose of the analysis was to study the impact of accounting harmonisation on financial reporting practices or on the policy choices by companies.

The results show that the comparability index for deferred tax increased although there is still a low level of harmony. Goodwill, however, showed no significant increase. The authors stated that little progress has been made in harmonisation but where such progress exists it is attributable to inter-national comparability.

Van der Tas (1992a) distinguished between international harmonisation of standards (formal harmonisation) and of accounting practices (substantive harmony). The harmonisation of national standards across countries affects international harmonisation of practices. Substantive harmonisation is influenced by IASs and US GAAP because they are internationally recognised.

'... to have an understanding of the processes of harmonisation, we believe that it is crucial to be able to identify, as we have done here, the different impacts of changes in comparability at the within- country and the between-country levels' (p.80).

Herrmann and Thomas (1995) state that harmonised practices are considered by some to be unnecessary (Goeltz, 1991) and potentially harmful (Fantl, 1971), even though international organisations consider harmonisation worthwhile. The authors note that environmental factors influence a nation's accounting system.

CHAPTER 4

ACCOUNTING ACROSS NATIONAL FRONTIERS

THE NEED FOR FURTHER HARMONISATION.

4.1. THE EUROPEAN UNION.

The European Union (EU) is made up of fifteen member countries from varied backgrounds and cultures, covers an area of 3.23 million square kilometres, and has a population in excess of 375 million.³⁷

The overall policy of the EU is to achieve a Community where the free movement of people, goods, services and capital can be assured - the single market. It is intended to provide a flexible and stable framework for the working together of neighbouring countries.

This chapter examines, in brief, the history behind this single market and how successful the European Commission has been in its attempts to draw the fifteen member states closer together with special reference to creating a closer, more harmonised regime within the accounting field.

The Community began after the Second World War when the Treaty of Paris, signed by Belgium, France, West Germany, Italy, Luxembourg and the Netherlands in 1951 established the European Coal and Steel Community (ECSC).

This was followed in 1957 when the same six countries signed The Treaty of Rome which established the European Economic Community (EEC) (or Common Market) and the European Atomic Energy Community (Euratom). In 1965 the three individual communities became collectively known as the European Community (EC).

The idea of the EC was to develop economic activity, promote expansion, increase stability and encourage closer relationships among the member states. This new common market it was argued, would allow the free movement of people, goods,

services and capital, and both trade and investment among the member states would increase. It was important that this common market created a unified business environment involving the harmonisation of company law and tax and a communal capital market. Any European country could apply for membership. The United Kingdom, Denmark and Ireland joined in 1973, Greece in 1981, and Portugal and Spain in 1986. In 1995 Austria, Sweden and Finland became the latest countries to join.

The Single European Act (SEA) came into force on 1 July 1987 and, by introducing constitutional changes to the three precursor special purpose communities, the EC ensured that the original aims of the Treaties of Paris and Rome³⁸ would become a reality by 31 December 1992. The heads of state of member countries set priorities including the free movement of capital and provided for further co-operation between the member countries to establish common policies.

In addition, The Treaty on European Union (*'The Maastricht Treaty'*) signed on 7 February 1992 was aimed at expanding the scope of existing responsibilities in the EC and bringing new policy areas under the jurisdiction of its institutions. It set out, *inter alia*, the procedure for a single currency as part of the economic and monetary union. This treaty established the idea of a European Union as opposed to the European Community.

With diversity of nationalities, languages, (the EU has nine official languages of which English, French and German is the most common) and cultures, a major question to be answered is: 'has this common market been achieved?'

In part, this question can be answered by reference to the Cassis de Dijon case.³⁹ In 1979, the European Court ruled that the German restrictions on the import of

³⁷ Eurostat Demographic Statistics, (1998). Italy: EC, 1999.

³⁸ The Treaty of Rome signed by the six founder member states can only be changed by an inter-governmental conference (IGC). The SEA and Maastricht constituted such IGC negotiations.

³⁹ Rewe- Zentralfinanz v Bundesmonopolverwaltung für Branntwein, case 120/78.

Cassis, (a low-proof liqueur),⁴⁰ into their country was contrary to the definition of freedom of trade between the states. Germany had banned the import because it did not meet certain important liquor criteria in Germany and so could not be allowed an unfair advantage in competition with similar German products. The Court ruled that a product from one country could not be restricted from entry into another on the basis of the product not meeting certain criteria laid down by an importing country because what was legally sold in one state was legally fit for sale in another. The trade principles of the Treaty of Rome took precedence over national legislation. This does not, however, mean that member states are unable to regulate the marketing of domestically produced goods.

The ruling has exposed many restrictions on the free cross-border movement of goods. It has focused attention on product regulations covering standards and descriptions across member states. Because of the complex product and standard regulations adopted by governments wanting to protect the consumers and the environment, the harmonisation of standards in the European Union has been shown to be a lengthy process. This has resulted in mutual recognition whereby a member country's goods and services should get free access to other member countries if they conform to certain basic requirements. This would prevent the situation arising whereby law is introduced into a member country long after the technology to which it refers has been deemed obsolete.

The decision in the Dijon case was followed when Germany unsuccessfully tried to ban imports of non-German beer, which it claimed was not brewed to the same standards as German beer.

Brasserie du Pêcheur, a French company based at Schiltigheim (Alsace), claimed that it was forced to discontinue exports of beer to Germany in late 1981 because the competent German authorities considered that the beer it produced did not comply with the Reinheitsgebot (purity requirement) laid down in para 9 and 10 of the Biersteuergesetz (Law on Beer Duty, BGBl. I, p. 149).

⁴⁰ Its alcohol content (15-20%) fell below the minimum permissible level of 25% set under German law.

The Commission took the view that those provisions were contrary to Article 30 of the EEC Treaty and brought infringement proceedings against the Federal Republic of Germany. The Court held that the prohibition on marketing beers imported from other Member States, which did not comply with the provisions in question, was incompatible with Article 30 of the Treaty.⁴¹

Brasserie du Pêcheur consequently brought an action against the Federal Republic of Germany for reparation of the loss suffered by it as a result of that import restriction.

These two cases illustrate the importance of case law in establishing a single market and point to the overall desire to ultimately eliminate trade barriers and remove borders within the EC. It also highlights the broad principles of mutual recognition.

Member-countries cannot prevent the import of a product from other member-countries because it competes with products from within their own territories. The fact that one member-state has different regulations on public health etc, does not entitle that state to prohibit the import and sale of products from another member state or vice versa.

By removing national barriers to the free flow of goods and services through the creation of the single market, new jobs and wealth should be brought about by an increased demand and a more competitive business environment. The single market for trade, (replacing fifteen individual markets), will ultimately result in the elimination of the social, economic and political barriers that have existed for centuries.

The Community's aim in company law is to create 'a homogeneous legal area, which would operate to the benefit of all interested parties' and would lead to a

⁴¹ *Judgement of 12 March 1987 in Case 178/84 Commission v Germany [1987] ECR 1227. Reported 1988, 1 C.M.L.R. 780.*

'harmonious development of economic activities within the Community and closer relations between its peoples.'⁴²

Although the procedures for establishing and maintaining subsidiaries or branches of companies in different EU countries are burdensome and do not encourage this commercial goal, changes in EC and national legislation are progressing towards a standard practice that will enhance and aid cross-border co-operation.

4.2. INSTITUTIONS OF THE EUROPEAN UNION.

There are four main institutions within the EU:

- The Commission;
- The Council;
- The European Parliament, and
- The Courts of Justice.

These institutions are established by the various Treaties which also give them their power and duties.

4.2.1. THE COMMISSION.

This is the executive and administrative institution of the EU and acts as the secretariat. Although located in Brussels a number of its services are also based in Luxembourg. It proposes legislation, manages the EU budget, negotiates trade agreements and ensures that rules, policies and regulations of the EU are implemented. Proposals of the Commission are placed before the Council of Ministers and the Commission also drafts measures to implement its proposals.

The Commissioners have specific responsibility for different areas and they take joint responsibility for all actions and proposals. In addition, the Commission is

⁴² European file, Company law in the EC, October 1989, 14/89.

served by Directorates-General designated as, for example, DG XV, which is the Directorate General of Internal Market and Financial Services.

4.2.2. THE COUNCIL.

This is the primary law-making body of the EU. It receives proposals for new legislation from the Commission and decides, after consultation with Parliament and the Economic and Social Committee, whether to adopt them. Presidency of the Council is held for six months by each member state in turn. Meetings are mainly in Brussels although there are some held in Luxembourg.

These meetings are convened in various forms:

The European Council which is made up of heads of state and foreign ministers, meeting twice a year to decide on EU policy and strategic direction.⁴³

The Council of Ministers that consists of Government Ministers from the fifteen member states representing national interests on the topic of the proposed legislation under discussion.

The Council is assisted by a Committee of Permanent Representatives (COREPER) which prepare and co-ordinate the work before it goes to the Council. COREPER, in turn, has specialist assistants to provide technical support and expertise.

4.2.3. THE EUROPEAN PARLIAMENT.

This is an elected body and represents the citizens of the EU. As its role is largely consultative, it gives opinions, which are not binding, on proposed legislation of the Commission to the Council and adopts, or rejects the EU budget. Parliament may question the Commission on its activities and may even censure or dismiss the Commission as was seen recently. Although plenary sessions take place at its

⁴³ The European Council is not a community institution but has evolved from regular meetings of heads of governments. These forums for discussions and to resolve political difficulties are held twice a year in the state that holds the presidency of the Council of Ministers.

formal seat in Strasbourg, some meetings are held in the administrative offices in Luxembourg. Most business and monthly committee meetings are held in Brussels.

4.2.4. THE COURTS OF JUSTICE.

These are made up of two EU courts responsible for the interpretation of community law. The Court of Justice (ECJ) is the highest authority and is assisted by the Court of First Instance.

The ECJ decides if the conduct of the Council, Governments, Commission and other EU institutions is compatible with the treaties in force at the time. It consists of 15 judges and 9 advocates-general who are responsible for presenting points of law and is independent of the other community institutions. Its rulings are binding, even in national courts. It has the power to overturn member states' legislation, which restricts or prohibits trade and no appeals are allowed. Cases normally presented in written form, can be brought to the Court by any of the Community institutions, member states, companies or individuals (in certain circumstances) and it is usual for three judges to sit on any particular case. Its role is very much in evidence through the growing amount of case law, which is an important part of the development of the Community's legal system.

All this would not be possible without the Court of First Instance established in 1988 under the SEA with the idea of easing the workload of the ECJ. Its jurisdiction, subject to a right of appeal to the ECJ, is limited to disputes by natural or legal persons against EC institutions, competition and anti-dumping cases and cases arising from the EU Trademark Registry. Although independent of the ECJ in its judicial functions, it uses the same administration departments in Luxembourg.

The legislative procedure is notoriously complex with each of the main institutions involved in differing degrees at different stages. In general terms it could be said that legislation is proposed by the Commission and adopted by the Council with the European Parliament.

The ideas for proposals come from many sources and there are five main legislative procedures:

1. Adoption by Council where Parliament is not involved.
2. Consultation procedure where the Commission issues draft proposals. Parliament gives an opinion, which Council may adopt.
3. Co-operation procedure, which was introduced by the SEA and gives Parliament a stronger role than in the consultation procedure. Here the Commission issues a draft proposal and Parliament gives an opinion. Council agrees the draft and then Parliament has three months in which to act. Should it reject or propose an amendment then the Commission has a further month to reconsider and submit a revised proposal for adoption by Council. If there is no adoption within three months then the proposal lapses.
4. Co-decision procedure was introduced by The Maastricht Treaty and gives Parliament stronger powers of veto and amendment. Parliament issues an opinion on the Commission's draft proposal and Council reaches a common position and sends the proposal to Parliament who may approve, reject, amend or give no opinion.
5. Assent procedure is where Parliament gives the Commission's draft a single reading at which time assent is given. There is no right to amend the proposal.

4.3. THE LEGISLATIVE PROCESS.

In order to create this common market of the fifteen member-states, legislation is constantly taking place. All secondary legislation (with which this thesis is concerned) must fall within the competence of one of the treaties (primary legislation). The treaties include, inter alia, Treaty of Rome, SEA and Treaty on EU. The various secondary legislation processes adopted are as follows:

4.3.1. REGULATIONS.

Regulations are legally binding throughout the EU and take precedence over national laws. They are equivalent to an Act of Parliament and are legislative measures usually issued by the Council, or by the Commission acting under delegated powers.

4.3.2. DIRECTIVES.

Directives are the most common forms of European legislation. They are legal instruments addressed to Member states, requiring them to achieve the necessary end result within a specified period of time. Each member-state can choose the form in which to implement the directives. Essentially the directives create a floor (a minimum set of rules) and no ceiling that each state must adopt and, as such, there can be a variance between states should they adopt or impose rules greater than that minimum.

4.3.3. DECISIONS.

They are only legally binding on those named in the decision. Those named could be individuals, companies or member- states. Decisions relate to specific issues as, for example, a claim for unfair competition made against a company or a decision on a commercial agreement to which the competition rules apply. These decisions are normally used for the administrative implementation of European law and can be challenged in the Courts of Justice.

There are, in addition, the decisions of the ECJ. All judgements are binding and may be given either on a reference from a national court or on proceedings brought before them directly. The ECJ often rules on whether certain legislative provisions adopted by member states are in conformity with Community law (especially the Directives), and in interpreting the validity of Community legislation.

4.4. THE EUROPEAN MONETARY SYSTEM.

Before dealing with accounting harmonisation it is useful to undertake a brief examination of the European Monetary System (EMS), as this may eliminate, at some future stage, the problems encountered in currency translations through the use of a common currency, such as the Euro.

Gray (1989, p.30) lists the benefits of using the Euro as:

- removal of differing fluctuations in the exchange rates of national currencies within Europe;
- stability in company cash flows within Europe;
- access to otherwise restricted credit markets, and thereby a greater range of financing resources;
- reduced costs of treasury operations - the creation of a single currency control institution instead of several small scale national units;
- internal transfer pricing stability;
- greater comparability of results by removing currency distortions and providing a common basis for evaluating performance

In 1969, the heads of state of the EU countries agreed that a plan should be drawn up to create, in stages, an economic and monetary union within the Community. The EMS was created in 1979 by a resolution of the European Council, followed by a decision of the Council of Ministers, and an agreement between participating central banks. The EMS aimed to establish a zone of monetary stability, which was intended to achieve both low inflation and stable exchange rates. The key to the operation of the EMS was the Exchange Rate Mechanism (ERM) and the Euro. The ERM was intended to be used for fixing exchange rates within the EMS by fixing bands for exchange rates between participating countries.

The Maastricht Treaty introduced the concept of a single economy and agreed a process and timetable for moving towards economic and monetary union (EMU). Under Article 39 of the Treaty on European Union, economic harmonisation calls for the 'irrevocable fixing of exchange rates leading to the introduction of a single currency, the Euro, and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both [being] to maintain price stability...' ⁴⁴

Dudley (1989) is of the view that the lack of a common currency is a weakness in, and undermines, the single market. Variations in exchange rates distort trade, increase foreign exchange risks and stimulate competition between countries to protect their trade balances and aggravate turbulence in the money market. Individual member states and companies operating in the market have no collective machinery to absorb shocks created by the market, which penalises competitive industries merely because of their location within the market place

On 1 January 1999 eleven member states joined EMU and accepted the Euro as their legal currency although at present each participating member state continues to use its own currency. ⁴⁵ The Euro can be used as a currency for settlements in foreign trade and inter-bank transactions as well as any other purpose that a member state believes is in its interest

4.5. ACCOUNTING PRACTICES.

The importance of the increased globalisation of the world's capital markets has highlighted a need for a form of 'world-wide accounting'. Strong equity markets have heavily influenced accounting practices of the past. The size of the UK and US stock markets created a predominance of Anglo-American companies, accounting firms and intermediaries, adding an additional stimulus to the current trend.

⁴⁴ The UK has negotiated the right for Parliament to decide whether or not to join the final stage in which a single currency would be established.

⁴⁵ National currencies are still in use. These will be replaced by Euro notes and coins from 1 January 2002.

Even so there are a great variety of practices within the UK and the US and also in the rest of the world. The variety persists not only between countries but also within the same country. Cross-border differences exist in accounting conventions, auditing standards and customs. Disclosure requirements for foreign firms must be determined.

In an early effort to create comparable financial statements in the US for domestic investors, the SEC introduced extensive disclosure requirements for companies listed on US stock exchanges. This practice of regulation has been applied in the UK where uniform rules from the Companies Act and Accounting Standards of the ASB are enforced.

Investment in any country can only be brought about by a thorough knowledge of what one is acquiring. Choi and Levich (1990) considered that 'accounting differences are important and affect the capital market decisions of a significant number of market participants.' Further evidence produced by Biddle and Saudagaran (1991) suggests that accounting, disclosure and regulatory requirements influence foreign exchange listing decisions.

An investor needs, in part, to understand the accounting rules of the particular country as these could well be crucial to an investment decision either within the country concerned or into a particular company. This presupposes both a knowledge and understanding of the accounting practices in the country and an ability to read and interpret the financial statements.

One way in which to ensure a user understands financial statements, is to highlight the differences in accounting practice. Having done this, the different meanings attributable to the terminology used, the local 'custom' and the use of options must be understood and interpreted.

In many member-states there is a great polarisation of the audit and accounting professions as compared to what exists in the UK. Auditors are specifically recognised professionals, governed by specific laws. In addition, they have their

own professional body and operate independently from those of the accounting profession.

4.6. ACCOUNTING DIRECTIVES.

In addition to directives dealing with the structure and management of public companies, (2nd and 5th Directives), auditors' qualifications, (8th Directive) and single member companies, (12th Directive), two Directives of relevance to this thesis were adopted by the EC and later introduced into national legislation by the member states. These are:

- The 4th Directive on annual company accounts, and
- The 7th Directive on consolidated accounts.

In 1990 the Commission announced that there would be no more major Directives on accounting. This recognised the slowness of the programme and the fact that the laws emanating from the Directives are inflexible to developments in the commercial world.

4.6.1. THE 4TH DIRECTIVE.

The 4th Directive was adopted by the Council of Ministers on 25 July 1978. Although its harmonising effects are limited by the large number of options allowed and by its lack of detail on many issues, it is nevertheless according to Van Hulle (1990a, p.5) 'the kingpin of accounting harmonisation'.

It deals with formats of financial statements, valuation methods, contents, accounting principles and the requirements for disclosure, publication and audit. Although many of its concepts are taken from the German Stock Corporation Law (the 1965 Aktiengesetz), there are, nevertheless, important accounting rules, which have been adopted by consensus of all member-states. These include the basic concepts of going concern, prudence, and matching.

The Directive does not try to formulate uniform standards in Europe but sets minimum legal conditions regarding the scope of published financial information. Its objective can be simply stated as being an attempt to ensure the equivalence and comparability of financial information published by more than three million companies, both public and private, within the EU. It has, at times, been argued that by allowing states to legislate beyond those minima and impose additional and more detailed rules, it could be said to create a situation where harmonisation is negatively affected.

Although the amount of disclosure is governed by three size criteria namely turnover, balance sheet total value and the number of employees, the 4th Directive forms a vital frame of reference for the 7th Directive.

The 4th Directive was brought into force in the three countries under review by national legislation, which took place in 1981 in the UK, 1983 in France and in 1985 in Germany. This 5-year span, in which the 4th Directive was adopted in these three countries, did little to help eliminate a wide variation in accounting practice. Eventually there was a resultant reduction in variations of accounting practice but it is unlikely to be entirely eliminated. This, of course, can be attributed to many individual reasons, such as different legal systems, nationalistic demands, the influence of taxation, etc.

With the adoption of an additional Directive (90/605/EEC) by the Council in November 1990, the scope both of the 4th and 7th Directives was extended to certain partnerships and unlimited companies with effect from 1995.

There are still problems to be solved and aspects of accounting, not dealt with in the Directive, such as deferred tax, leases, goodwill, etc, to be covered. There also seems to be a need for the reduction of options in the Directive, which could then aid and improve the comparability of the financial statements between member states. [For further discussion on the 4th Directive see Chapter 6].

4.6.2. THE 7TH DIRECTIVE.

The 7th Directive, adopted in 1983, and implemented in 1985 in France and Germany and in 1989 in the UK, deals with the preparation of consolidated accounts and is based, in the main, on UK practice. A reason for using UK practice is that consolidation has been relatively insignificant in the other member states and that the UK, with its long history of application, was best equipped to provide the base for this particular directive.

The basis for consolidation is the legal power of control exercised by the parent company over the subsidiary. This could be by a control of voting or the appointment of members of the board or through a specific contract.

Its adoption is a further step forward towards comparability in financial statements. In France and Germany, for example, where the rules of accounting are largely influenced by taxation and other legal requirements, various adjustments are made to adapt individual audited accounts when preparing consolidated accounts, as the latter are not prepared for the tax authorities.⁴⁶ In applying these different rules, the member states in question make use of international standards as set down by the IASC and, to that extent, it does seem as though the harmonisation gap is closing.

This was well illustrated in the listing by Daimler-Benz on the New York Stock Exchange. Daimler-Benz faced a formidable task of trying to comply with the US accounting requirements but the company found a number of similarities in accounting rules.⁴⁷ The company was criticised by other German companies when it sought this listing on the New York Stock Exchange, and, as reported by Liener it was said that 'the company betrayed German accounting.' He conceded however that the group 'probably opened up the door for German accounting (to be

⁴⁶ The requirements for the preparation of consolidated accounts were not seen as a priority for many years. In Germany the 1965 requirement relates only to domestic subsidiary companies and in France the COB limited their requirements to listed companies issuing new shares.

⁴⁷ Dr. Gerhard Liener, Chief financial officer of Daimler-Benz in an address to the conference of the IASC, London, 1993.

influenced by the rules of other countries) further than it has been in a long time.
[For further discussion on the 7th Directive see Chapter 6].

While both the 4th and 7th Directives provide for annual audits by an independent expert, they do not establish rules for the qualifications of auditors. The 8th Directive, adopted in 1984, defines the qualifications of auditors such as the need to pass approved professional examinations and sets out the theoretical and practical training required

4.7. ACCOUNTING DIFFERENCES.

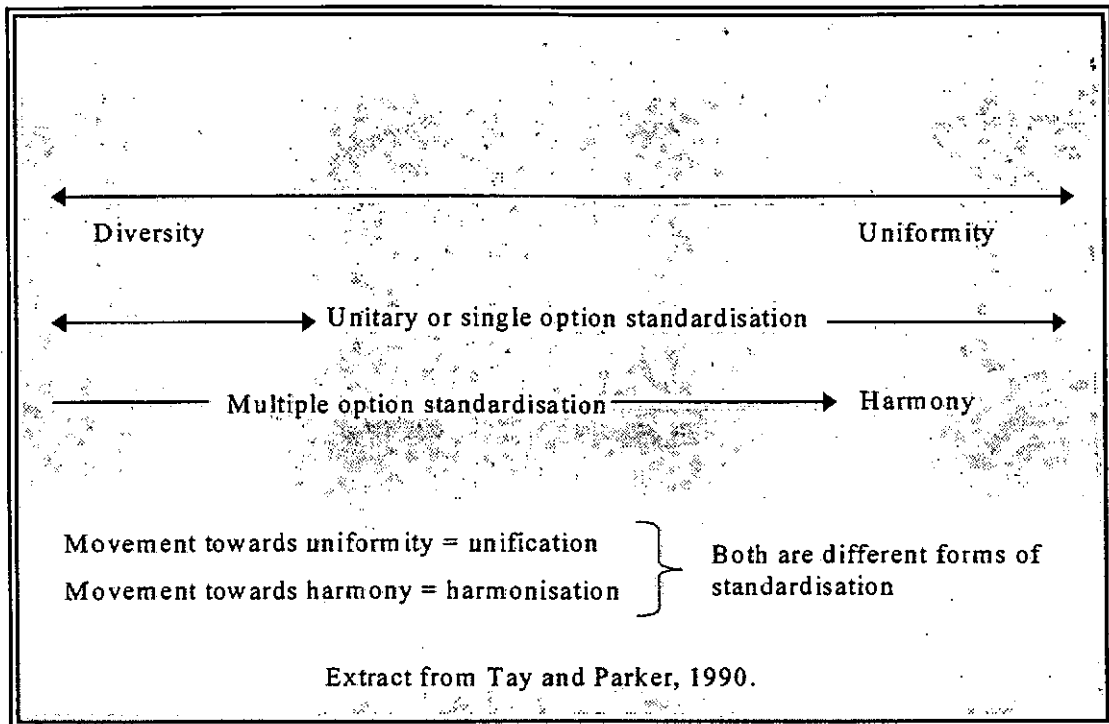
The diversity and multiplicity of national accounting standards and practices create an obstacle for international investors and analysts. Before a detailed examination can take place of the accounting differences, it is important to draw a distinction between two words, which are commonly used - harmonisation and standardisation. [Earlier discussion on this is covered in Chapter 3].

Nobes and Parker (2000, p.66) have described harmonisation as the process of increasing the comparability of accounting practices by setting bounds to their degree of variation. In so doing it decreases but does not eliminate the differences in accounting standards and practice although it does make them more reconcilable with each other. Standardisation, on the other hand, is a process, which leads to a uniformity of accounting records and financial statements. Standardisation as practised throughout the world, can lead to either harmony (a blend of practices or the co-existence of different practices) or uniformity (the elimination of several national practices and the operation of one set of practices throughout the region). This distinction in terminology is not always followed and harmonisation is commonly used only in the international context.

Arpan and Radebaugh (1985) contend that there are major pressures for harmonisation such as the growth of international business and the increased need for capital. In addition there are many other obstacles, as the accounts must reflect a true and fair view to shareholders and a prudent view to creditors and tax collectors. The lack of enforcement of international standards, the diversity of

national enforcement agencies and the nationalistic beliefs in the superiority of one's own practices, all lead to different standards in various member states and the preference of harmonisation over unification.

Figure 2 The continuum from diversity to uniformity



The EU has attempted to harmonise accounting standards since 1978 and although it now has a common format through the introduction of the various Directives, the substance remains different. 'Profit' is not the same in all countries and accounting theory and practice is still dominated by the information needs of specific investors and the tax authorities. Little agreement exists between member states as to who the users are of the financial statements.

While ongoing attempts are being made to improve domestic accounting standards in the UK these are not necessarily in line with the rest of the EU. Other member states are now increasingly adopting IAS or US GAAP in their consolidated accounts. This movement is encouraged by the view of the EC as long ago as 1990, when they agreed that Directives take too long to bring into force.

4.8. ACCOUNTANCY PROFESSION.

Smith and Hannah (1991) are of the opinion that the 'accounting profession misleads as much as it reveals.' An example of this statement is in pension fund accounting where the difference between the book value of the fund and the contributions into the fund is shown as one figure (profit) and the user may think that the difference is indeed a profit. In dealing with the profession as it exists, it must be noted that the legal background to accounting differs from statute law and historic codification in Germany and France to a system based on case law in the UK. Added to this is the situation that in Germany and France financial accounts are also used for tax purposes. The idea that a variety of valuation bases may be used within one set of financial accounts is more generally accepted in the UK, but is a new concept in continental Europe. Theoretical influence from academic argument is also more important in the UK where debate on accounting issues is publicly reported. Academic views as researched by Ullathorne (1993) seem to have had little effect in France and Germany where legal requirements are paramount.

The regulation of the accountancy profession in the EU is at national level, although there is variation in the degree of state involvement. In the UK, at one extreme, the government, through the DTI, has devolved authority completely to the professional bodies to regulate registration and supervise examinations.⁴⁸ In both Germany and France authority rests with the state-appointed agencies rather than professional bodies. The governments in those countries control the rules of accounting and auditing, and accounting standards developed by professional accountancy bodies, such as international accounting standards, do not have the same status as in the UK. This does not mean that IASC standards are ignored, or that the profession in those countries is non-existent or immature. It rather implies that national differences are such that rules of accounting are regulated by their governments and not by the profession, as is the case in the UK.

⁴⁸ The audit profession in the UK is the only one authorised by the state to be its own regulatory and supervisory body.

The accountancy profession itself has varying levels of influence on accounting practice and the small numbers of members of the accountancy professions in European countries (except the UK), may have arisen because the accountancy profession in Continental Europe means the auditing profession. The accountancy profession in each country, however, acts on behalf of its members and operates within the regulatory framework of the state.

Hofstede (1991) as cited by Margerison (1993, p.23) argues that the lack of consensus across different countries as to what represents proper accounting methods is because their purpose is cultural not technical. He quotes Hofstede (1991, p.157) as saying:

In Germany, which scores highly on uncertainty avoidance, annual reports to shareholders are supposed to use the same valuation of the company's assets as is used for fiscal purposes; in the Dutch, British and US systems, reports to the tax authorities are a completely different thing from reports to shareholders.

The Ruding Committee (1992)⁴⁹ reported that taxable income in the community 'is as a rule' computed on the basis of 'sound commercial accounting principles' and is thus related to the profits reported in company accounts. It recommended that 'commercial accounts produced for financial reporting purposes should form the starting point for the computation of taxable income in all member states.'

The Ruding Committee refers to a 'close linkage' in some countries and recommends that the commission 'take appropriate measures to reduce the differences between commercial accounts and the accounts used for tax purposes.'

Financial conformity implies substantial reliance on the principle that choice of a particular accounting practice in the financial statements is conclusive for tax

⁴⁹ The commission appointed a 'Committee of Experts' to investigate the possibility of further reforms to the taxation of income from capital. The mandate given was primarily concerned with the degree to which existing tax systems create economic distortions in an international environment. The committee reported back in 1992 and recommended that discrimination against investors or locations resulting from the complex system of taxing transnational flows should be removed.

purposes and that inclusion of particular items therein is a necessary precondition for the grant of tax relief.

The report says that unlike tax returns, financial reports 'are prepared for a wide range of users who are primarily concerned with the economic performance and the financial position of the enterprise.'

The extent of conformity between financial reports and tax returns is determined by reference to the law and practice in each country. There is no specific statutory requirement in the UK that accounts must be kept as a basis for the computation of the tax liability. Various phrases are used to describe the principles to be applied, including 'ordinary principles of commercial trading', 'sound accountancy principles', 'sound commercial accountancy practice', 'current accountancy practice', 'established principles of sound commercial accounting', 'correct principles of commercial accountancy', 'ordinary principles of commercial accounting.'

Tiley as reported by Radcliffe (1993) identifies two distinct approaches to understanding the relationship between tax law and accounting principles

The single balance sheet is well established in many countries. It is a product of a compromise among several different valuation criteria. In France and some other Continental European countries strict adherence to financial conformity with accounting treatment is decisive for tax purposes. Choice of a specific policy for accounting purposes should, according to Radcliffe (1993) be binding for tax purposes only where legislation or case law requires financial conformity and, in other cases, adjustment is theoretically possible through the *liasse fiscale* (i.e. adjustments outside the accounts).

4.9. THE FUTURE.

Notwithstanding the harmonisation process and the adoption of the 4th and 7th Directives, major accounting differences continue to exist between the member states. A reason for these differences is that the 4th and 7th Directives, in common

with all the other Directives, establishes a minimum compliance and allows member states many options. resulting in national regulations that are difficult to harmonise. In many cases these differences are of major importance and will not be eliminated in the short-term. This necessitates making adjustments in order to create a uniform basis of comparison

In the UK, The Financial Reporting Council (FRC) in its report 'The State of Financial Reporting - a review' (November 1991, p.36) stated:

The variety of accounting practices around the world remains a major source of concern both for standard setters and for preparers and users of accounts. Multinational companies increasingly look for consistency throughout all the countries in which they operate. Consistency reduces the internal costs of a multinational in collecting, processing and disseminating financial information. More significantly it makes for clear reporting of performance and financial position to an international audience of shareholders, creditors and potential investors. As the technical and political barriers to global capital markets are progressively eroded, the need for high quality universally understood financial reporting becomes even more insistent.

Seven years on, the ASB in their annual review⁵⁰ state that 'all the Board's work on new standards has been concerned with international harmonisation. The Board has accepted the argument that there should really be only one way of accounting for similar transactions throughout the world.' In its efforts the ASB tries to align their standards with the IASC and therefore adherence to UK standards should result in compliance with IASCs standards.

They acknowledge the case for harmonisation, but state that there are formidable obstacles to its achievement. These, in their view, are because of legal and national backgrounds and differing approaches to accounting objectives. The barrier is, in many cases, the tax regime of the country, so that accounts are not in line with

⁵⁰ FRC 1998, Annual Review, London: 1999.

current business practices. Other obstacles that impinge on uniform accounting practices are the existence of diverse capital markets and the influence of the accounting profession.

Although the FRC wants to see a decoupling of taxation treatment from accounting treatment in key areas like depreciation, there will, nevertheless, be other, more deep-rooted problem areas, such as differing legal systems, which need attention, if the full benefits of harmonisation are to be achieved.

4.10. THE LEGAL SYSTEM.

One barrier to the harmonisation of accounting practice is the legal systems existing in the member states.

There are two categories of legal systems operating within the EU:

- the English common law system that is usually predominated by unwritten laws, and
- the Roman system generally codified (in commercial codes and accounting plans), which operates throughout most of continental Europe.

In France and Germany laws amend the commercial codes. In addition, in France a great deal of the detail is contained in an accounting plan, which is prepared by a Government committee and enforced by law.⁵¹

In 1947 the French Accounting Plan was created as a result of the nationalisation and economic planning of the post-war government. Before and during the Second World War, it was considered that nationalisation would allow for a reform in the economy and improve labour conditions. According to Fortin (1991, p.3), this movement resulted in the appointment of a committee to study the planning and control of accounting information and ultimately led to the introduction of the accounting plan.

⁵¹ This is dealt with in detail in Chapter 7 under the three countries.

Nationalised industries such as Renault and Air France were the first to have the plan applied to them but eventually it was extended to private industry. The 1982 revised plan had an improved presentation and made changes to the chart of accounts. Accounting principles are now specified and notes to the accounts are now shown as an integral part of the financial statements. Emphasis is also placed on more schedules, which is possibly the effect of the 4th Directive's need for a 'true and fair' view.

The legal background is such that the law tries to cover all eventualities. Company law and other government controls lay down specific rules of valuation, income measurement and account formats.

This is in contrast to the English common law system, where the rules are created by established accounting standards. There are limited government-controlled rules, (statute law) and professional judgement is supplemented by accounting standards. Although in the past UK businesses have been fairly free to decide how and what they publish in their accounting reports,⁵² this freedom has, to some extent, been curtailed now by the introduction of the Companies Act amendment of 1989. This act regulates accounting in the UK to a far greater degree than before.

Statute law is interpreted by the Courts as case law that then supplements the statutes. This allows for flexibility and the exercise of professional judgement, although it could be said to be inefficient in certain respects.

To address the various systems, the EU adopted a 'reconciliatory, synthesis-oriented' process which faced great difficulties due to the divergent judiciary and accounting systems encountered in the member countries. To harmonise accounting, two apparently conflicting views had to be dealt with by the Commission.

⁵² UK company law has not prescribed many rules.

4.11. FINANCIAL STATEMENTS.

Through an examination of accounting differences in a number of member states, it is possible to highlight the incentive that exists for further harmonisation. It is self-evident that if the basic reports are prepared on a different, non-uniform basis, then the consolidated group financial statements cannot be published without redrafting, or restating the individual accounts to a uniform, harmonised, basis.

The annual accounts are prepared for assorted user groups whose reliance on the annual reports varies from country to country. In the UK, the primary audience of the annual reports is the individual shareholders, who have access to no other information. In France and Germany corporate finance is provided less by individual shareholders and more by the government, banks or family members, many or all of whom are usually board members and are thus able to obtain information additional to that provided in the financial statements. These parties have access to internal financial information and as such there is little demand for developing external reporting unlike the situation where there are outside shareholders who demand external reports.

This means therefore, that statements would not have to contain as much detail or explanation as would be the case in the UK, as it is presupposed that, should they require additional information, it would be easily obtained direct from the company.

Because of this lack of need for full disclosure of information, consolidated accounts were rare, as were audited accounts, even though the 4th Directive allowed an exemption for small companies.

It was only in 1985 that German law extended its publication and audit requirements insofar as the publication of group financial statements were concerned, but even then, only a very insignificant percentage of companies complied.

The UK, in contrast, required publication and audit for all limited companies but this has now been changed to exclude small companies in the UK from audit requirements.

There are, of course other external influences on accounting disclosure such as where listed companies need to generate financial reports that comply with the reporting requirements of stock exchanges. Where the company is quoted in more than one country then it must comply with requirements in all the countries. Some companies use international standards when consolidating and also provide a reconciliation of the net income or the net assets from a company's domestic set of rules to another set, as for example under SEC regulations. Additionally they may publish a substantial reworking and re-translation of the financial statements into another set of practices and terms. An example of this, using the information given by BT in their annual report is shown in appendix 1. This requirement is laid down by the NYSE for any company listed or seeking a listing on its exchange.

In France, consolidated accounts deliberately present a more 'international' approach because they are free of the traditional local constraints, for example, tax laws. This trend continues to grow and is also evident in the case of the German groups (see Chapter 7).

Language differences are also a consideration to be borne in mind in examining a set of financial statements. The translations may be unreliable or misleading. The translated accounts are an attempt to provide users with a language version that is not the language of the member state and, as such, may be seen to be convenience translations which could result in words being incorrectly translated and in groupings of various account headings. As such the convenience translations are not official documents and they do not have to obey the rules of any other member-state which means that they may be extracts or manipulations of the original statements. Language difference is a complex problem in a technical area like accounting, for example 'conversion' is used interchangeably with 'translation', or 'surplus values' instead of 'goodwill'.

Each of the three countries examined here has its own form of private and public company, and although there are additional national variations such as limited partnerships, this is considered to be outside the scope of the research being undertaken. The designation of the companies are detailed below (Table 4.1) in their abbreviated form.⁵³

Table 4.1 Designations of Private and Public Companies

	France	Germany	UK
Private	Sarl	GmbH	Ltd
Public	SA	AG	PLC

The directives adopted apply to all these forms of companies as well as to the other local variations. In addition, the applications of the Directives are not limited to companies and partnerships and other forms of trading are also covered.

The differences between private and other limited companies is important and exemptions from the application of the Directives are given, in the main, to private companies, depending on their size. Publication requirements cover fewer companies in most member states than in the UK. There appears to be a greater disclosure in the UK than in the other countries being examined.

4.12. CONCLUSION.

There is a constant need to make comparisons between companies and groups of companies based in different EU countries.

⁵³

Sarl- Société à responsabilité limitée.
 SA- Société Anonyme
 GmbH- Gesellschaft mit beschränkter Haftung
 AG - Aktiengesellschaft
 Ltd - Limited
 PLC - Public limited company.

Although it can be argued that the information needed is contained in the financial statements, the question arises as to the extent to which comparisons can be made between the accounts of the various member states.

The adoption of the 4th and 7th Directives has led, in part, to a more harmonised body of accounting practice. Nevertheless, with the strong influence that still exists by the taxation authorities in France and Germany as well as the national, legal, social and cultural differences between all the member states, a wide gap still remains. These differences could be lost, overlooked or even misinterpreted and those who use financial statements for investment analysis or any other purpose, must constantly be aware of these differences and adjust for them on a very methodical basis.

The need for adjustment also applies when preparing consolidated accounts and it is for this reason that more emphasis should be placed on narrowing the gap so that closer harmonisation can prevail.

Further harmonisation can only be of immeasurable benefit to the EU, the international business community and all users of financial statements and it is essential that member states publish equivalent and comparable financial information. This will help develop the European capital market and the growth of mergers and acquisitions.

Harmonisation of accounting rules, being an alternative workable option for the EU, will not lead to uniform standards of accounting practice in the foreseeable future, as national traditions, cultures, histories and business and accounting practices will remain alongside an ever-changing economic environment. It is to be hoped that the responsible bodies of professionals in each member-state will be able to exert an influence on their respective governments to encourage speedy and necessary changes, which will ultimately lead to a closer harmonisation and a greater degree of usefulness in financial statements.

CHAPTER 5

THE DIVERSITY OF ACCOUNTING PRACTICES, STANDARDS AND THE TRUE AND FAIR VIEW.

5.1. INTRODUCTION.

The increased international trading of European-based multinationals, many of which are now listed on more than one Stock Exchange in addition to the listing on their domestic Stock Exchange, is one of the reasons for an increased interest in transnational financial reporting in the E.U.

Several obstacles including language barriers, use of different currencies and different accounting conventions have been identified (Archer and McLeay, 1989 and 1991). Many companies produce versions of reports that differ not only in translation but also in the application of accounting conventions (Stafford, 1993). This chapter examines accounting standards and accounting practice in the three member states and the current accounting measurement and disclosure practices.

5.2. IS THE VALUATION GAP CLOSING?

There is considerable international variation in the bases for valuation. For example, where there are detailed legal requirements the valuation system would require the exercise of little or no judgement. This is, for example, the case in Germany, where valuation is based on a strict form of historical cost and no use has been made of the 4th Directive option allowing revaluation to current cost.

In examining the many varied methods of valuation that can be utilised by EU member-states this chapter reviews the current practices adopted by France, Germany and the UK.

Before the adoption of the 4th Directive in each country, extremely detailed rules of valuation existed in France and Germany but not in the UK. This has now changed

in the UK with the adoption of the 4th Directive and the incorporation of its provisions into Schedule 4 of the Companies Act.

In spite of all this, there remain many areas where different interpretations, applications of conservatism and the need for disclosures lead to alternate valuation methods. This is possible because the 4th Directive not only allows each member-state a choice from among various valuation options, but also allows each member-state to legislate in excess of the minimum requirements set out in the Directive.

Diversity in permitted valuation methods adds strength to the case for further European harmonisation in accounting. In addition, as the methods of valuation used are a foundation on which individual financial statements and group accounts are based, it is important to investigate the current practice of asset and liability valuation in greater depth.

5.3. THE TRUE AND FAIR VIEW.

At the outset, sight must not be lost of the fact that the 4th Directive has an overriding requirement - that the accounts present a true and fair view. This provision takes priority over all specific accounting regulation. As a result further disclosures or departures from national practice may be necessary in order to project such a view.

5.3.1. THE ORIGINS OF THE TRUE AND FAIR VIEW.

The phrase 'true and fair view' was introduced into UK Company Law⁵⁴ in 1947. This concept has been reported on by UK auditors for over 50 years and is central to accounting in the UK. In fact it is one of its fundamental characteristics. It would seem therefore that this concept was clearly defined, if not in UK Company law where there has never been a judicial interpretation on the concept, then, at least, in the minds of the auditors (Walton 1991, p.24).

⁵⁴ Section 149(4).

Although there is no definition of the term in UK legislation various attempts to define true and fair view have been made. In 1958 the ICAEW in its statement (N18) recorded the following:

A true and fair view implies appropriate classification and groupings of items and therefore the balance sheet needs to show in summary form the amounts of the share capital, reserves and liabilities as on the balance sheet date and the amounts of the assets representing them, together with sufficient information to indicate the general nature of the items. A true and fair view also implies consistent application of generally accepted principles.

This statement seems to indicate that consistency in the application of accounting principles is a necessity if the true and fair view is to be portrayed. If the true and fair view is normally obtained by compliance with GAAP (Walton 1991, p.16) then it could be argued that any judgement of truth and fairness rests with accountants and varies internationally.

Ordelheide (1996, p.498) argues that an 'unclear term' such as 'true and fair view' needs to be interpreted consistently all over Europe. He contends that this is supported by the jurisdiction of the European Court (ECJ). Using various decisions of the ECJ he is of the opinion that 'member states are not allowed to interpret European norms differently because of different national traditions or national legislation.' He cites article 177 of the Treaty as giving the ECJ the authority to make such decisions. This view re-enforces that in an earlier article (Ordelheide, 1993, p.82) where he stated that the true and fair principle is a 'European accounting principle' and not a UK principle to be determined by British accountants. He contends that an accounting principle, which complies with the valuation rules of the 4th Directive, is in accordance with the general norm. He cites (p.88) an official statement by the Council of Ministers and the commission as an explanation to Art 2(4). This statement reads: 'The Council and the Commission conclude that it is normally sufficient to apply the Directive in order to provide the desired true and fair view.'

His view is endorsed by van Hulle and Van der Tas (1995, p.317) who argue that the ultimate explanation of a term (such as the true and fair view) included in a Directive can only be provided by the ECJ.

In the UK there is a tradition of professional judgement not influenced by written rules. Ordelheide (1996, p.504) however argues this when he says that accountants 'undervalue the importance and relevance of these (ECJ and EC) European institutions.' He questions whether accounting rules are 'national monuments worth being preserved?'

In the UK it was always assumed that the true and fair view should be left to the accountants to determine and that although the law would set out certain guidelines, and even minimum requirements, the 'fine tuning' would be left to the profession. This results in the meaning being different at various times and this subjective approach is in sharp contrast to that in the other member states, where the emphasis is more on confirming that the legal requirements had been adhered to, rather than emphasising the 'fairness' of the accounts.

Considerable research has been undertaken in the UK on the true and fair view concept and how it operates in practice. A survey of company directors by Nobes and Parker (1991, p.353) indicated that they take no specific action to give a true and fair view, relying rather on their auditors for compliance, and, in any case, are unable to distinguish between 'true' and 'fair'.

In a questionnaire, supplemented by a structured interview with the 'top 20' UK audit firms at the time, Higson and Blake, (1993a, p.14) reported that 16 respondents could and did distinguish truth and fairness and were able to give an interpretation as to the meaning of 'true' and 'fair'.

In a later survey by Higson and Blake (1993b, p.111), over 50% of UK practitioners interviewed had reservations about the phrase 'true and fair' and if it reflected what the auditor was trying to say about the financial statement. Of those interviewed 14 accepted it and 11 rejected it. The study 'highlighted some concern

as to whether the phrase 'a true and fair view' really reflects the message the auditor is trying to communicate'. (Higson and Blake 1993b, p.112).

Some member-states, in adopting the true and fair view, have chosen to describe it in one term rather than two and this seems to indicate that the meaning between the two words is difficult to distinguish. This was shown in the Nobes and Parker (1991, p.364) survey where UK directors could not distinguish between 'true' and 'fair'. A further lack of shared meaning between accountants and shareholders of the concept was shown by Houghton (1987) in his empirical study into the meaning of a true and fair view, as perceived by accountants and shareholders. The research seemed to indicate that accountants and shareholders do not share the same meaning for true and fair, nor do they share similar cognitive structures. Instead, according to the research, professional accountants demonstrated more complex cognitive structures than lay people did. This condensation of Houghton's work was cited by Stafford (1993, p.173) in her literature review of linguistic issues.

In the UK, following the requirements of the 4th Directive, the Companies Act 1985 states that where compliance is not sufficient to give a true and fair view, then notes to the accounts must be used in order to adequately convey this view. True and fair view is a legal concept which can only be interpreted by the Courts, but compliance with accounting principles and disclosure requirements of the Companies Act 1985 may, according to Hoffman and Arden (1983) be considered as *prima facie* evidence that the accounts are true and fair.

In a subsequent opinion by Arden (1993a, p.123) it was pointed out that 'the true and fair view is a dynamic concept...(and) is subject to continuous rebirth...'. In Arden's view (1993, p.123) the Court 'will not seek to find synonyms for the words 'true' and 'fair' but will seek to apply the concepts which those words imply.' In her opinion it was the view of the UK that was considered in the interpretation of the true and fair view and not a more all-embracing European view.

Ordelheide (1993, p.82) considers that the answer given to the problem by Alexander (1993), that 'true and fair is what British accountants declare it to be' is

provocative. He believes that while this may be correct in describing British practice, the determination of the meaning is one that can only be undertaken by the European Court.

5.3.2. THE INTRODUCTION TO THE 4TH DIRECTIVE.

In tracing the origins of the true and fair view concept, it is notable that §149 (1) of the AktG was used in the first draft of the 4th Directive. In doing so it made use of the provision that states that accounts (in Germany) must follow GoB and must be clear and well set out.⁵⁵

As a consequence, in the original 1971 draft of the 4th Directive (clause 2) it states that annual accounts 'shall conform to the principles of regular and proper accounting'. At the time there was no agreement as to what was meant by such accounting principles. Niehus (1972, p.94) was of the opinion that what were conspicuously absent were the words 'true and fair'.

In February 1973, the Economic and Social Committee issued an opinion, which suggested that the draft 4th Directive should have a requirement to give a faithful view. It was felt that it corresponded to the Anglo-Saxon 'true and fair view' which it considered was based on the application of 'generally accepted accounting principles'.⁵⁶ Although this suggestion was not adopted the 1974 draft shows the Anglo-Saxon influence in a new clause 2 of article 2.

The final version of the 4th Directive included the true and fair view in Article 2(3). It required that annual accounts give a true and fair view of the company's assets, liabilities, financial position and profit or loss. Brown (1984, p.35) considered that the introduction of the 'true and fair' view was possibly the most innovative feature of the 4th Directive.

⁵⁵ The term 'klar und übersichtlich' is used.

⁵⁶ It was at this time that the UK and Ireland joined the EC and so introduced the Anglo-Saxon influence.

Table 5.1 The history of the true and fair view in the 4th Directive

<p>1971 Draft (article 2)</p> <ol style="list-style-type: none">2. The annual accounts shall conform to the principles of regular and proper accounting.3. They shall be drawn up clearly and, in the context of the provisions regarding the valuation of assets and liabilities and the layout of accounts, shall reflect as accurately as possible the company's assets, liabilities, financial position and results. <p>1974 Draft (article 2)</p> <ol style="list-style-type: none">2. The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and results.3. They shall be drawn up clearly and in conformity with the provisions of the Directive. <p>1978 Final (article 2)</p> <ol style="list-style-type: none">2. They shall be drawn up clearly and in accordance with the provisions of the Directive.3. The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.4. Where the application of the provisions of this Directive would not be sufficient to give a true and fair view within the meaning of paragraph 3, additional information must be given.5. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The member states may define the exceptional cases in question and lay down the relevant special rules.6. The member states may authorise or require the disclosures in the annual accounts of other information as well as that, which must be disclosed in accordance with this Directive.

With the true and fair view being a requirement of the 4th Directive, a user, placing reliance on financial statements, must consider if it is consistently applied

throughout the EU. Lee (1994, p.30) argues that the true and fair view is a means by which users of annual reports are informed about the overall quality of disclosure in annual reports.

Walton (1991, p.5) states that 'it seems therefore that while the true and fair view was successfully exported to the European Community, the version taken up was a modified one, and the result of its adoption has been to modify in turn the original true and fair signified in Britain.'

While all member-states have complied with the 'true and fair view' requirement and the need for additional disclosure, Germany together with Austria, Finland and Sweden, does not require, nor permit, a departure from the detailed requirements of its law to give a true and fair view.

Germany continues its use of accurate bookkeeping (GoB) to satisfy the detailed accounting rules and the tax authorities. The strict application of valuation and classification rules does raise the risk of conflict with the true and fair view. This is evident in the strict use of historical cost, the influence of tax laws and the various methods of valuation.

5.3.3. INTERPRETING THE TRUE AND FAIR VIEW.

The true and fair view requirement is a new concept in France and Germany, having been introduced into France in 1984 and Germany in 1987.

True and fair view is not an absolute concept; it is relative to the time and place of use. The concept is an overriding one⁵⁷ and the intention is that there should be some way of avoiding the blind application of the Directive where individual circumstances warrant it. Article 2(4) of the 4th Directive states that where the application of the provisions of the Directive are not sufficient to give a true and fair view then additional information must be given.⁵⁸

⁵⁷ The Companies Act (1995) requires UK companies to override the accounting provisions in law if the departure would enable accounts to present a true and fair view.

⁵⁸ The disclosures should either be included or cross-referenced in the note required under paragraph 36A of Schedule 4 of the Companies Act.

Many attempts have been made to interpret the meaning of the true and fair view. In 1981 Lee said that accounting standards apply to all financial statements whose purpose is to give a true and fair view. He was of the view that the portrayal of a true and fair view was dynamic and would change over time. But it was not until the Companies Act amendments (1989) that UK companies were required to state if the accounts were prepared in accordance with accounting standards. Standards were given statutory recognition in the Companies Act and the ASB was empowered to make, amend or withdraw them on its own authority.

Lee (1981) considered the true and fair view concept and believed that in addition to preparing accounts using accepted accounting principles, the preparer also used 'accurate figures as far as possible and reasonable estimates otherwise...' These accounts were then to show 'as objective a picture as possible, free from wilful bias, distortion, manipulation, or concealment of material facts.' Lee (1981, p. 270) ended his definition of true and fair by stating that 'the spirit as well as the letter of the law must be observed.'

The concept was described by Rutterman (1991) as 'fairness of presentation' implying a lack of bias between the different users of financial information and their varying needs, and the 'recognition of economic substance rather than mere legal form.'

Large companies must, by law, state whether or not they have followed applicable accounting standards and give reasons for any material departure from them.

In the UK, the UITF issued Abstract no.7 (1992) to give guidance on the interpretation of the required detail of any departure from the need to observe true and fair view requirements. The UITF stated that where this override is used it must be clearly and unambiguously stated in the notes to the accounts. These notes must also disclose the reasons and their effect, so as to provide the reader of the accounts with information on the position had the normal rules in the Act been applied. This is deemed necessary in order to assist in achieving the equivalence of information available in respect of companies not only in the UK but also throughout the EU.

The UITF have indicated that the statutory disclosure requirements should be interpreted as follows:

- particulars of any such departure - a statement of the treatment which the Act would normally require and what was actually adopted;
- the reasons for it - why the treatment prescribed would not give a true and fair view;
- its effect - a description of how the position shown in the accounts is different as a result of the departure, normally with quantification.

Walton (1993) considers that the term represents one or more of the following three basic ideas:

- a legal residual clause;
- an independent concept;
- GAAP.

Alexander (1993) argues that the implementation and interpretation of the true and fair view in each member country varied. The variation was either the requirement to comply with accounting rules drawn up by each country in observance of the provision of 4th Directive, or to override accounting rules if, by doing so, they would be presenting a true and fair view of the company's affairs.

The opinion by Arden (1993a, pp.122-123) obtained by the ASB has suggested that accounts prepared on the basis of FRSS issued by the ASB are more likely to be construed by the courts as meeting the true and fair view requirements. This is because the ASB, unlike the ASC, no longer reflects the view of the accounting profession given its broad membership, its partial government funding and its statutory recognition.

Where the EC considers that authoritative clarification is required for any Directive, then it too issues a communication. This was the case when an

interpretative communication of the EC (1998) was issued concerning certain articles of the 4th and 7th Directives. This communication dealt with the true and fair view and raised the question of 'exceptional cases'. Under article 2(5), member states were allowed to define these cases but it was stated that they were not to 'introduce an accounting rule of a general nature which is contrary to provisions of the Directive, nor can they use this sentence to create additional options allowing for accounting treatments which are not in conformity with the Directive.'

5.4. NATIONAL ACCOUNTING STANDARDS.

Accounting law has made considerable progress over the past few years with the international dimension being an essential element. Changes have taken place and the major role players have been the IASC and the EU.

Diversity and multiplicity of national accounting standards, procedures and practices form a stumbling block for international investors, creditors, analysts and multinational enterprises. Harmonisation tries to lessen (but not eliminate) differences and make them more reconcilable with each other.

A distinction should be made between mandatory and non-mandatory standards. The EU standards are mandatory and according to Gelders (1986, p.122), these standards are 'efficient' but lead also to difficulties in harmonisation. No country would readily agree to a standard where its individual approach is altered. They would only agree to adopt alternative options. Non-mandatory standards include IASs, which could be said to be weak, as they are neither legally binding nor enforceable in any country unless that particular country adopts them within its own law.

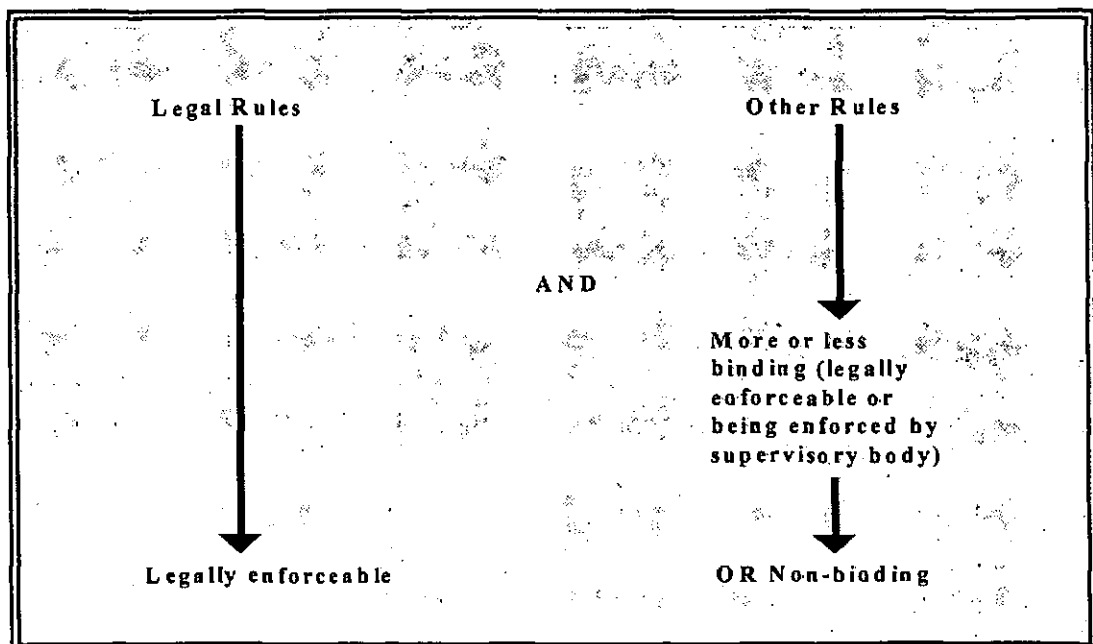
Accounting law and its harmonisation is essentially a political question. 'To believe that accounting law is a purely technical affair is to hide one's head in the sand' (Arpan and Radebaugh, 1985, p.329). There is an ongoing clash of national and international interests. It is certainly not merely a technical affair, as, when a member-state incorporates the provisions of a Directive into its law, it must take into account the situation in its neighbouring states and be aware that it is creating,

to the detriment of its own enterprises, distortions of competition with firms in other non-EU states who are not obliged to disclose the same or similar information.

Accounting standards cannot give priority to one single requirement or even to international harmonisation. They must take into account economic and political dimensions and ensure consistency. No accounting standards are set identically as in some states standards are set by law while in other states by the profession. But having set standards it is important to ensure that they are complied with at all times. They can either be enforced by a self-regulating accountancy profession or by law or by a combination of both. Some countries ensure the legal enforcement of standards by either incorporating them into law, giving authority to law, e.g. Germany, or giving legal backing to the standard setting body e.g. the UK.

Standards themselves, even if identical, can be interpreted in different ways. This depends on factors such as the differences in the duties accountants perform, the certification process, training and sophistication, and ethical standards and behaviour.

Figure 3 The division of accounting rules



Substantial cluster study research has been undertaken in an attempt to group countries according to their specific accounting practices and standards. It is outside the scope of this thesis to deal with these aspects but for completeness, it should be noted that one of the first large-scale categorisation of countries according to specific accounting practices and standards was undertaken in 1977 by Watt, Hammer and Burge.⁵⁹ Having analysed published accounts of 45 countries they identified 5 such clusters where classification was made using the probability of fair presentation. These were:

- A group where fair presentation was broadly equivalent to US standards. This group included the UK.
- The second cluster was where statutory requirements approached US standards but there were some valuation principles, which were not acceptable in the US. Germany was included in this group.
- The third cluster was where tax legislation was a predominant influence. This group included France and Germany.

The remaining two clusters consisted of one where fair presentation was based on standards from Canada, US or the UK but there was a greater difference in the number and extent of principles.

The final cluster was where statutory requirements do not equate to US standards. In this group only two countries – Spain and Switzerland - appeared.

Nair and Frank (1980), in their research, showed the UK in the British Commonwealth Model and France and Germany in the Continental European Model. [This is discussed in Chapter 3].

These works were attempts to show not only that countries fit into different groups, but also how close or distant these groups are between themselves. As an example

⁵⁹ Cited by Arpan and Radebaugh, pp. 329-335.

it can be shown that German accounting is different, but not too different from that of France.

This was endorsed in a recent paper where Nobes (1998) distinguished between two groups of countries. The former exist where there is a strong equity holding and the latter in a weak equity holding. Both France and Germany are in the latter group but it was emphasised that this was the classification at the time.

5.4.1. FRANCE.

French accounting principles are contained in national legislation and various regulatory texts. These are clarified and supplemented by authoritative pronouncements issued by the National Accounting Board. Generally accepted accounting principles (GAAP) are derived from the commercial code (Code de Commerce) and the accounting plan (Plan Comptable Général - PCG). Numerous laws and decrees govern accounting practice in France, but the most important is the PCG, which is a highly detailed accounting guide [See Chapter 7].

5.4.2. GERMANY.

In Germany, accounting principles are contained in the Commercial Code amended in 1985 to incorporate the provisions of the 4th and 7th Directives, and also the pronouncements of the Institute of Certified Public Accountants (Institut der Wirtschaftsprüfer - IdW), which are highly respected but not automatically followed [See Chapter 7].

One concept that exists in Germany is that the commercial financial statements form an authoritative basis for tax accounts, which are not an independent set of financial statements, but merely 'derived' from the commercial financial statements. Many tax incentives can only be claimed if treatment of a particular item in the commercial accounts and tax accounts is identical.

5.4.3. UNITED KINGDOM.

In the UK, accounting standards are micro-based, pragmatic and business practice orientated and although similar to the US, they have a greater degree of legal enforcement. An accounting standard setting body has been in existence since 1969 and all companies were obliged to produce true and fair accounts but the meaning of the term was a matter for the courts whose decision would be influenced by the standards and GAAP. Until 1989, although the publication of defective accounts was a criminal offence, there was no legal remedy for the correction of these accounts. The law was concerned with the prosecution of the directors and not in securing good accounting information.

The establishment in the UK of the Financial Reporting Council (FRC) in 1990 to oversee the setting of standards and their creation by the Accounting Standards Board (ASB) has now altered the way in which accounting standards are adopted. The FRC, ASB and Financial Reporting Review Panel (FRRP) has strong government support but are not government controlled. They are part of the private process of self-regulation. The ASB commenced operations on 1 August 1990 and has as its function the remit to make, amend and withdraw accounting standards. These standards are 'accounting standards' for purposes of the accounting requirements of the Companies Act [See Chapter 7].

5.5. INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE.

The IASC is an independent private sector body formed in 1973 to develop and publish International Accounting Standards (IAS) for the improvement and harmonisation of financial reporting. At present it has a membership of over 140 professional accountancy bodies from more than 100 countries.

As the IASC does not have any way of enforcing standards, they are not always adopted and put into practice. It largely depends on recognition and support for its work from many different interest groups, acting within their own jurisdictions.

The IASC has to-date issued 40 International Standards (of which 34 are currently operative) as well as numerous Exposure Drafts, dealing with the substantial majority of topics that affect the financial statements of business enterprises [See Appendix 4]. These standards according to the secretary-general in the 1998 annual review deal with 'all major areas of importance to general business' and are sufficiently detailed and comprehensive to allow for a uniform interpretation in all countries. They are used as an international benchmark by national and regional standard setting bodies, stock exchanges and companies and, in some cases, as a basis for national and regional requirements.

In 1987 the IASC began work which was aimed at increasing international harmonisation. An important development was the publication in an Exposure Draft (E32) of proposals to reduce the options in the standards, improve disclosure and provide more implementation guidance in an effort to achieve greater uniformity and comparability of financial statements. The objective of all this was to persuade the securities regulators, especially The International Organisation of Securities Commissions (IOSCO) and through it the Securities Exchange Commission (SEC), to accept financial statements prepared in accordance with IASs for multinational listings.

One of IOSCOs major interests is the facilitation of multinational securities offerings and it argues that different national accounting requirements are an impediment to such offerings. It sees mutually acceptable international standards as a critical goal and is actively encouraging the IASC to meet this goal. As a result the Exposure Draft was followed up by a Statement of Intent on the Comparability of Financial Statements (July 1990) which showed the agreed revisions to be made by the IASC.

As long ago as June 1993, M.Saint Geours, President of COB and Chairman of the IOSCO technical committee, said that the time seemed ripe for IOSCO to give its approval to a revised set of international standards. By the end of 1993 the 'Comparability of Financial Statements' programme was completed which

eliminated many options in ten IASs. In the few cases where options remained they were indicated as a 'benchmark treatment' and an 'allowed alternative'.⁶⁰

The term 'benchmark treatment' was an accommodation to IOSCO and was not intended to infer that the treatment was the preferred one. It was anticipated that any company selecting the alternative treatment would prepare a reconciliation to the benchmark should this be required by IOSCO although not a requirement of IASC.

In 1994, pre-1992 standards, which had not been revised, were reformatted using the style adopted in the revised standards. Other changes and improvements were also made in disclosures to meet the demands of the capital markets and the international business community.

Since that date the IASC has moved forward at a rapid pace and in 1995 received the endorsement of IOSCO.⁶¹ This together with further progress to date may indicate that the IASC is well poised to have IASs adopted by all major stock exchange regulators.⁶²

In May 2000, IOSCO recommended that its members permit incoming multinational issuers to use the core standards (indicated as 'the IASC 2000 standards') to prepare their financial statements for cross-border offerings and listings.

Although supplemental treatment may be required, such as reconciliation of certain items or additional disclosure, this recommendation does provide a core set of international standards, which are acceptable as a basis for financial reporting by foreign companies on all major stock exchanges. In a report after the meeting in

⁶⁰ An example was IAS 16 where the benchmark is cost less accumulated depreciation and the allowed alternative is the revalued asset amount less accumulated depreciation.

⁶¹ In July 1995 the IASC and IOSCO issued a joint press release announcing an agreed 4 year programme for further improvements and new standards that was designed to lead to IOSCO endorsement.

⁶² The acceptance by the SEC of IAS 7 allows companies to prepare cash flow statements without any need to reconcile to US GAAP.

Sydney, Australia, The Times (22 May 2000) reported that 'this means that the IASC standards will become the harmonised financial reporting rules worldwide.'

The European Commission in its Communication on Accounting Harmonisation (November 1995), indicated that it intended to add input into IASC standards rather than try to develop its own European accounting standards. Additionally it would examine the possibility of EU companies being permitted to prepare their consolidated accounts on the basis of IASs. This could only be allowed if there was no conflict with the Directives.⁶³ In the past year both France and Germany have indicated their support for 'international standards' but this applies not only to IASs but also US GAAP.

The FEE called for increased harmonisation of financial reporting standards for Europe. They suggested that there be separate EU legislation for listed companies and that harmonisation be based on the consolidated accounts of listed companies. Individual accounts would remain governed by legislation of directives. This would allow European companies to apply IASs to their consolidated accounts without any restraint.

The task of national standard setters in moving towards harmonisation would certainly be eased if there were a greater readiness among the legal, fiscal and regulatory authorities in the countries concerned to favour adoption of internationally agreed standards and this current trend seems to show a favourable step in this direction.

The motivation for the convergence of thinking which national standard setters are beginning to seek lies in an underlying recognition of the pressures from the changing environment. There is a growing awareness that one country's problem today is another's tomorrow. Initially this awareness arises at the technical level as standard setters seek to respond in their respective environments to economic and financial phenomena.

⁶³ The Contact committee of the EU examined the conformity between IAS (in force in 1995) and the EC Directives and found only 2 minor conflicts (negative goodwill and the consolidation of subsidiaries with dissimilar activities).

In the UK the ASB has framed its own programme with reference to the IASC and other international developments. The ASB intends to examine the international pronouncements and to ascertain whether they could be adopted in the UK.

Whether this signifies a meeting up of standards internationally is still an open question. David Tweedie (outgoing Chairman of the ASB) who was one of the UK representatives on the IASC has now been appointed (29 June 2000) as the incoming IASC board chairman under the new IASC constitution.

It is the pressure of the market that must ultimately bring about the more fundamental changes needed for financial reporting to overcome current fiscal, legal and regulatory constraints. Financial statements are used as a tool for communicating useful information on financial performance to investors in world-wide markets. As a result pressures for change are building up from within each country as opposed to an external demand. It will be for each country to work out for itself the particular means through which the barriers to change can be overcome.

In France, where the pressure for change in this area came not so much from the standard setter or the accounting profession but from multinational business, legislation has already identified certain accounting methods which, though not acceptable for the accounts of individual companies, can be used for the purposes of consolidated accounts. Concessions such as this enable progress towards international harmonisation to get underway.

In 1994 Bayer adopted IASs in its consolidated accounts for the first time. It was the first major German company to make such a move since the Daimler-Benz decision in 1993 to report under US GAAP. In announcing the reason for change Bernd-Loachim Menn, a director of Bayer and an IASC Board representative stated:

*We have become an international group with potential investors throughout the world. It is important that we provide information to these users so that they can readily compare us with other multinational groups of companies. IASs provide us with a body of rules which is widely accepted and which we have some influence in developing. US GAAP does not allow us this input. By reporting under IAS we can better meet the needs of all our investors.*⁶⁴

Many other German companies have followed and the law has also been changed to allow the use of IASs. Dr. Herbert Biener, at the time German Ministry of Justice said

*the Commission of the EU has failed to obtain mutual recognition of the EU's financial statements from the SEC. If IOSCO is successful, further harmonisation of accounting regulations within the EU will be superfluous. The German government would prefer to drop the accounting Directives. The new approach would be to support the world-wide harmonisation process in the interest of large companies.*⁶⁵

*...global playing (German) enterprises have the unpleasant experience that investors and financial analysts mistrust the financial statements of some German firms. ...in the interest of German conglomerates operating world-wide, the German government supports the declared aim of IOSCO and IASC to reach agreement on mutually acceptable international standards of accounting and disclosure.*⁶⁶

⁶⁴ Insight, March 1995, p.3.

⁶⁵ Insight, June 1995, p.5.

⁶⁶ CONSOB, Italy, June 1995.

5.6. VALUATION METHODS.

In order to improve the quality of the financial statements there is the need for ensuring an adequate amount of information and a correct evaluation of items. It is necessary to examine the valuation methods adopted by the member states being reviewed in this thesis.

At the outset it must be clearly stated that there is an ongoing dispute between the use of historical cost and current cost. The two approaches continue to co-exist and endanger comparability of accounts. Niessen (1986, p.125) considered that it was vital that if use was to be made of current cost, then historical cost should also be shown.

The adoption of the 4th Directive and the valuation rules contained in section 7 have not eliminated the many problems to be solved in order to achieve equivalence and comparability of financial information within the EU.

The 4th Directive provides general principles of valuation by which items must be valued and departures from the general principles, which include going concern, prudence and consistency, are only permitted in exceptional cases. Even then they must be disclosed in the notes with reasons and their effects on the financial statements.

All items shown in the annual accounts are valued in accordance with Articles 34 to 42 of the 4th Directive, which are based on the principle of purchase price or production cost. Having stated this, member states can derogate from Article 32 and are able to permit or require valuation by replacement or other methods to allow for inflation, or to allow for revaluations. In these instances the difference between the method used and that in terms of article 32 (the general rule), must be shown as a revaluation reserve. It is clear that not only are the reduction of options desirable but, more especially, the method of valuation should be clearly stated.

It now remains to examine specific methods of valuation as they relate to the items dealt with in this thesis. Although this will be done in detail in Chapter 8, a brief overview is given in the sub-sections below.

5.6.1. INTANGIBLE FIXED ASSETS.

Often intangibles are more important than tangible assets and accounting for intangibles is an increasingly important problem. This seems to be borne out by the data available from the sample groups studied.

The table below shows the significance of intangible assets as compared to equity. Based on these facts 17% of the sample accounted for intangibles whose value exceeded 50% of the group equity, while another 24% disclosed that the value of the group intangibles was in excess of 15% of the group equity. It must be borne in mind that the past practice, especially in the UK, of writing off goodwill by companies has resulted in a lower disclosed figure for intangibles.

Table 5.2 Percentage of intangible value to equity

	Value of intangibles (as % of equity)			
	France	Germany	UK	Total
0 to 15%	4	8	7	19
15 to 50%	5	1	1	7
Over 50%	2	1	2	5

Although their valuation is covered in the 4th Directive, there is still a great divergence in methods within the EU. High expenditure on advertising, research and development etc, is difficult to value as business assets, although an intangible such as a brand name, for example, is a valuable asset.

Intangibles can fall into two categories:

- Identifiable intangibles such as research and development; and
- Unidentifiable intangibles such as goodwill.

Whatever the category, the problem is that there is an absence of clarity on fundamental measurement issues. Companies may record intangible assets at their purchase price. Formation expenses and research and development expenses may be capitalised and brand names can be separately identified and valued. All must be written off over a maximum period of five years (Art 34) but derogations are allowed as long as they are disclosed. This allows items to be written off over a period exceeding five years, providing that the period does not exceed the useful economic life of the asset (Art 37(2)).

Goodwill is determined at the date of acquisition of a subsidiary and is either calculated on the basis of the book value existing at the date of purchase or on the fair value of net assets.

5.6.2. FOREIGN CURRENCY TRANSLATION.

One omission from both the 4th and 7th Directives was a method of dealing with foreign currency transactions and the accounting principles to be applied in consolidating company accounts expressed in foreign currencies.

There is an ongoing concern over exchange rates and currency risk. Rates do have an impact on company reports and their results. Questions that need be answered are:

How are losses and profits determined; what debt is due by currency - this gives an indication of exposure level; how can management avoid risks - do they hedge or speculate?

How are the gains and losses shown and are they shown before they are realised; what method of translation is used from subsidiary to parent company and how are hyper-inflationary countries dealt with in translations?

When group accounts are prepared there is the need to have all subsidiaries expressed in one currency. Maybe now with the Euro this will become easier but for our purposes we must consider the situation without the Euro and how it is handled in all countries of the world.

The profit and loss and balance sheet of all foreign subsidiaries must be translated into the home currency. For this purpose there are two main methods:

- Closing rate/net investment method (current rate method) where it is argued that the parent's interest in the subsidiary is its net investment and that this should be restated to reflect the current exchange rates.
- Temporal method (monetary/non-monetary method) where the parent company and the subsidiary are one entity and the latter's activities and assets and liabilities are an extension of the parent company.

The appropriate method should be used and this is dependent on:

- How the parent and subsidiary are linked;
- If the subsidiary depends on the parent company's currency and not its own; and
- If the cash flows of the subsidiary impact directly on the parent.

It is important when analysing the financial statements to determine which method is used by the parent. Often both methods are used, as each would be more relevant to a particular subsidiary.

It is not the function here to discuss risk and the types of risk that a company or group may be exposed to nor to the methods used to deal with these risks. All this falls within the area of finance.

5.6.3. PENSIONS.

The 4th Directive stipulates that a 'provision for liabilities and charges' be shown in the balance sheet. These liabilities and charges are ones that are almost certain but have uncertain amounts.⁶⁷ One item included in this heading is provisions for pensions.

The problem of a provision is to determine the amount that must be set aside and the 4th Directive does not set out how or what method is to be used to determine the size of any provision. Where conservatism is in operation, then larger provisions are made and current profits are reduced. This is often the case in Germany where provisions are made to lower dividends paid out and to keep back some 'secret reserves'.

A major item of provisions is pension payments. The system of accounting for pensions varies and so does the accounting treatment.

Disclosure too can vary as can be seen from an examination of a typical UK financial statement with that of a German group.

5.6.4. DEFERRED TAX.

A major deferred charge is for tax. This can only happen when tax is not yet due but is taken into account such as in the case of accelerated depreciation. Deferred tax will then arise as a result of the recognition of the effect of timing differences. It is a major issue in the UK, but of lesser importance in the other member states such as Germany, where accounting and taxation are closely related.

⁶⁷ If an outcome were uncertain then the only record made would be as a contingency. This implies that a liability may arise as a result of some future event. This is not so in the case of a provision.

There are two main reasons for the imbalance:

- Income shown is tax-free and certain expenditure cannot be set-off against other taxable income. In these cases there are permanent differences between taxable and accounting profits.
- Items included in a period are treated in a different period for taxation purposes. This gives rise to a timing difference. In the case of accelerated depreciation / capital allowances this too creates a timing difference as the allowances exceed the depreciation charged in the accounts.

Deferred tax can be computed using a full provision basis or a partial provision basis. The former takes into account the full tax effects in the period while the latter requires that deferred tax be only accounted for when it is likely that such a liability will crystallise.

In the case of a going concern there is a hard core of timing differences which are permanently deferred as the timing difference is replaced by another before it crystallises.

There are two methods of computing deferred tax:

- The deferral method, which uses the tax rates when the differences arise and which has no adjustment later.
- The liability method where the rate used is that estimated to be the tax that will be paid (or recovered) when the timing differences reverse.

In some cases expense items are not allowed for tax purposes (e.g. formation expenses in the UK) and as such they are added back to the accounting profit when calculating the tax liability.

This is a permanent difference because it is permanently disallowed even in future accounting periods. But there are other expenses, which can be allowed for tax purposes but only at a later date. These are differences in timing as the tax relief is at a different time to when they are charged to the profit and loss account. This

could happen when using accruals for the profit and loss account but the accrued amounts are not allowed in tax claims. An example is interest payable which does not get tax relief until it is actually paid. Depreciation is the most notable timing difference where it is charged in the profit and loss account and then added back in the tax computation and replaced by a capital allowance calculated under tax rules.

This means that corporation tax is paid on a lower amount than the accounting profit in the earlier years of an asset's life but higher in later accounting periods when the capital allowance is lower than the depreciation claimed.

This process of paying tax on a profit lower than that reported in early years and higher in later years is known as reversal. Ultimately the timing differences will reverse and under the accruals concept a deferred tax provision must be made for future liability where the tax is calculated on the lower figure.

5.6.5. LEASES.

Once again there is no information contained in the 4th Directive on how leases are to be accounted for in the financial statements. In addition no definition is given to show a distinction between the finance lease and the operating lease.

5.7. CONCLUSION.

This chapter has attempted to show the diversity between the three member states being reviewed. It serves as a caution to those users of accounts who are unaware of the different and varied accounting practices in the EU. Different valuation methods, accounting practices, standards and the interpretation of the true and fair view can have far-reaching results in the determination of asset values of a company and also in its profitability. In calculating share values, rates of return and the many other ratios used by financial analysts, great care should be taken to ensure that those calculations are taken from a common base. Whatever adjustments are necessary are made to the true and fair financial statements already prepared by the company, or group, being reviewed.

CHAPTER 6

THE EUROPEAN ACCOUNTING DIRECTIVES.

6.1. AN INTRODUCTION TO THE 4TH DIRECTIVE.

The 4th Directive (78/660/EEC of 25 July 1978) issued in 1978 was the result of almost a decade of debate and consultation between EU member states. Even then the directive would not have been issued had there not been many compromises, an ignoring of certain accounting issues and the introduction of options.

This Directive, in common with all Directives deals with general principles and does not aim at regulating all possible practical applications. The following table illustrates the differences between the EC Directives and International accounting standards.

Table 6.I A Comparison of EC Accounting Directives and International Accounting Standards

EC Directives	International accounting standards
Deals with general principles	Deals with specific accounting issues
Not regulate all applications	Very detailed guidance
Applies to all companies	Deals mainly with listed companies
Compulsory application	Voluntary application- market driven
Forms part of the legal system	No link to legislation of the country
Consideration given to the environment of the member state, e.g. tax link, creditor protection.	Standards not linked to national environment and only has abstract rules
Contains minimum disclosure requirements	Disclosures are more demanding

6.2. PRINCIPLES OF THE 4TH DIRECTIVE.

Although the 4th Directive covers most accounting measurement and disclosure issues, the options allow for a considerable divergence in practice between member states. These are areas where various subjects are either only briefly treated in the 4th Directive or else the Directive is silent on the various accounting aspects.⁶⁸ They include valuation principles on acquisitions by exchange, construction contracts, grants and leasing where no mention is made at all in the 4th Directive. They also include other principles and practices covering deferred tax, foreign currency translations, pensions and segmental reporting, where there is a requirement to make some form of disclosure in the notes on the accounts.

The 4th Directive also co-ordinates the presentation and content of annual accounts and reports and stipulates the need for these annual accounts to give a true and fair view and utilise the mandatory layouts contained within the Directive.

The Directive details the form that annual accounts should take and the fact that companies, subject to certain exemptions, must present audited accounts.

6.3. THE EFFECTS OF THE DIRECTIVE ON HARMONISATION.

As a result of the many options, there are still major differences in reporting practices in the EU member states and although the process of harmonisation continues to take place, problems do still exist. This is evident from the study in 1989 by Touche, Ross and Co in their publication *Accounting for Europe*, part of which is set out in summary form in Tables 6.2 and 6.3 below.

The problems should not, however, be seen as detracting in any way from the harmonisation process. Van Hulle (1990b, p.2) was of the view that 'Community accounting legislation is still in its early stages but it has had a major influence on the daily lives of several million businesses in the Community. It has also enabled the Community to play an active part in the international discussions aimed at harmonising accounting rules at world level.'

Table 6.2 Comparison of Profit Achieved and Profit Sensitivity

Millions of ECU	Belgium	Germany	Spain	France	Italy	Netherlands	UK
Operating profit	274	261	250	264	243	264	289
Net Profit	135	133	131	149	174	140	192
Maximum achievable	193	140	192	160	193	156	194
Most likely	135	133	131	149	174	140	192
Minimum achievable	90	27	121	121	167	76	171

Source: Accounting for Europe, (1989, pp. 33 and 36).

Table 6.3 Comparison of Return on net assets

Millions of ECU	Belgium	Germany	Spain	France	Italy	Netherlands	UK
Net profit	135	133	131	149	174	140	192
Net Assets	726	649	722	710	751	704	712
Return (%)	18.6	20.5	18.2	21.0	23.2	19.9	27.0

Source: Accounting for Europe, (1989, p.42).

At an EC conference in Brussels (1990) the then EC Director General for financial institutions and company law, Mr G Fitchew, stated that it was recognised

... that the situation was not perfect, in the sense that gaps and deficiencies exist. In particular, it was not possible to say that there is as good comparability between accounts from different Member States as would be desirable for efficient functioning of the internal market and financial markets in particular.

He was of the view that '...the need to remove differences of interpretation was recognised, as was the need to study in depth the lacunae of the 4th Directive.'

6.4. CONTENTS OF THE 4TH DIRECTIVE.

The preamble to the Directive states that:

- co ordination of presentation and content of annual accounts;
- valuation methods used; and
- publication and audit of annual reports.

are important for the protection of members and third parties.

Within the 4th Directive (Sects 3 and 5), a mandatory layout is prescribed for the balance sheet and profit and loss account (see appendix 2) as are minimum contents to notes on the accounts. It also provides for auditing (with small company exemptions), and requires group accounts (and anticipates the 7th Directive) for any company within a group and states that these accounts should give a true and fair view of the activities of the group. It does accept that derogations may be granted for certain companies of minor economic or social importance.

The following are of some of the more important topics dealt with in the 4th Directive insofar as they relate to this thesis:

6.4.1. ACCOUNTS MUST PRESENT A TRUE AND FAIR VIEW.

'The annual accounts shall give a true and fair view of a company's assets, liabilities, financial position and profit or loss.' The 4th Directive in introducing this concept of a true and fair view (Art 2(3)) requires companies to go beyond the mere application of legal provisions and give the user a more 'reliable' picture of the financial position of the company. It also requires in Art 2(4) that additional information must be given where the application of the provisions of the 4th Directive are not sufficient to give a true and fair view.

The Directive also states that specific provisions of the 4th Directive must be departed from, where, in exceptional cases, the application is incompatible with the obligation to give a true and fair view. When this is done then there is an obligation to disclose the departure in the notes on the accounts and explain the reasons for it and its effect on the assets, liabilities, financial position and profit or loss (Art 2 (5)).

The introduction of the term 'exceptional cases' is not defined and in fact the Directive allows the member states to establish their own definitions. This, it could be argued, detracts even further from the attempts at harmonisation as member states can, at their option, elect to adopt the true and fair override or not.

The words 'true and fair view' were inserted into the draft, maybe on the behest of the UK where they had attained operational usefulness. The true and fair view concept is central to accounting in the UK and is one of the fundamental characteristics of accounting. Although it is a new concept in France and Germany, UK Company law has required it since 1947. It has been 'exported' to other countries even though there has never been a judicial interpretation on the concept. It is assumed that compliance with the rules of the 4th Directive will ensure that the 'true and fair' requirement will be met. [Discussion on the true and fair view is contained in Chapter 5].

6.4.2. VALUATION RULES.

Different valuation methods for assets and liabilities must be co-ordinated to ensure that the annual accounts disclose comparable and equivalent information. The valuation rules of the 4th Directive as set out in Section 7 (Art 31-42) include general and specific rules. These rules combine a mixture of rigidity and flexibility⁶⁹ as can be seen in Table 6.4 below. Under Art 31(2) it is possible, in exceptional cases to depart from the general principles, provided that the departures are fully disclosed in the notes to the accounts and reasons for the departure are given.

⁶⁹ Van Hulle (1991, p.25) illustrates rigidity as being of layout, valuation rules, content of notes and the audit requirements. He contends that there is flexibility with regard to the true and fair view override, the options of the directives, the fact that the provisions of the directives are minimum requirements and the possibility to derogate in exceptional circumstances.

Table 6.4 A division of rules

Rigid rules	Flexible rules
Germany and France	United Kingdom
Legalistic and prescriptive systems	Legal and accounting systems allow flexibility and the exercise of judgement

The general principles of valuation are set out in Article 31.1 (a) to (e) and are based on the following accounting concepts:

- (a) The going concern concept, under which accounts are prepared on the basis of the entities carrying on business as a going concern for the foreseeable future.
- (b) Consistency, where accounting policies are applied consistently within the same financial statement and from one year to the next.
- (c) The prudence concept, where only realised profits are accounted for and all losses or liabilities that have arisen, or are likely to arise, in respect of the financial year, or a previous financial year are recorded, even if they only become apparent after balance sheet date.
- (d) The accruals concept where all income and charges relating to the financial year are taken into account without regard to the date of receipt or payment.
- (e) In determining the aggregate amount of any item, the amount of each individual asset or liability that makes up that item is determined separately. This prevents the netting out of assets and liabilities into a single net figure.

In this way the 4th Directive attempts to achieve elements of harmonisation by establishing common accounting principles to be applied in all member states while still allowing each member state considerable scope in their own methods of valuation.

Even with the application of these principles, harmonisation is not always achieved, as different interpretations, can be contradictory. An example is in the case of Germany, which is traditionally more conservative than the UK. As a result, profits in the UK tend to be higher than they would be if the same information were prepared according to German principles [See Tables 6.2 and 6.3].

Prior to the adoption of the 4th Directive, extremely detailed rules of valuation existed in France and Germany. Now, as a result of the adoption of the 4th Directive, these rules also apply in the UK and are contained in Schedule 4 of the Companies Act. There are many areas, however, where different interpretations and the application of conservatism and disclosure lead to alternate valuation methods. For example, items in the annual accounts can be shown at historical cost or an alternative value, as long as the alternative value is fully disclosed in the notes and is allowed for under national legislation.

The methods used in company valuations are a foundation on which group consolidated accounts are subsequently prepared. It is important to be aware of the divergences in valuation, as this will have a profound effect on both profits and asset values of a company and the group. While it is agreed that in many instances notes to the accounts highlight the practices adopted, that in itself is no indicator of the amounts involved [See Chapter 5].

6.5. TAX INFLUENCE ON ACCOUNTS.

In the 4th Directive provision is made for particular information to be supplied in the notes on valuation to satisfy fiscal legislation.⁷⁰ This arises because of the difficulties in preventing the fiscal authorities influencing the accounts and not because of a determination to achieve a particular result.⁷¹

In the 7th Directive member states are encouraged to legislate to eliminate the effect of fiscal legislation on the accounts when consolidated. Art 29.5 of the 7th Directive

⁷⁰ Art 35.1(d), art 39.1 (e) and art 43.1(10).

⁷¹ Art 35 and 39 permit fixed and current assets to be the subject of exceptional value adjustments for tax purposes provided the amount and reasons are stated in the notes.

states that where assets have been the subject of exceptional value adjustments solely for tax purposes, then the differences are to be eliminated prior to consolidation. There would be no problem with this where member states have a close tax/accounting link as consolidated accounts are not used for tax purposes. Once again, however, in a compromise with member states, the 7th Directive allows a consolidation without the elimination of the adjustments as long as there is suitable disclosure in the notes. This includes the disclosure of the amounts and the reasons for not eliminating adjustments.

6.6. ACCOUNTING TREATMENT EXCLUDED FROM THE 4TH DIRECTIVE.

In section 6.2 accounting issues both as concerns valuation and disclosure not dealt with in the 4th Directive, were detailed. While a number of these are not the subject of this thesis, the others are summarised as follows:

6.6.1. DEFERRED TAX.

Although Article 43.1(11) refers to the provision for deferred taxation it does not require it to be recorded in the accounts but instead requires disclosure in the notes to the accounts if the amount is material. This being the only reference there is no prescribed accounting method for its disclosure and consequently various methods are used.

- The deferral method where tax balances are not adjusted to reflect changes in the tax rate or the imposition of new taxes.
- The liability method where the deferred tax balances are adjusted.

[This topic is dealt with in detail in Chapter 8].

6.6.2. PENSIONS.

There appears to be glaring contradictions in the 4th Directive on the disclosure of provisions for pensions. In the liability side of the balance sheet layout (see

appendix 2) of article 9, B.1 and article 10, J.1, the Directive requires the disclosure of provisions for pensions and similar obligations. Article 43 dealing with the contents of the notes has two requirements. Under (7) the notes to the accounts must show the total amount of any financial commitments not included in the balance sheet and disclose the pensions separately, while under (12) emoluments as well as commitments in respect of retirement pensions are to be disclosed in the notes. Reading these articles together seems to indicate that a company is free to decide if the provision should be shown as a liability or in the notes.

Because of the different social practices there are different forms of pension provision, which vary from underfunded state schemes to fully funded schemes managed by independent experts [For details see Chapter 8]. As a result there is a variety of accounting practices for the provision of pension liabilities.

The 4th Directive does not require details of any specific accounting or actuarial methods to determine the pension commitments. It is also argued that it is not the intention of the directive to make member states account for these commitments but only to disclose the amount in the notes if not shown in the balance sheet.

6.6.3. LEASING.

This type of transaction is dealt with indirectly as a financial commitment and is not included in the balance sheet. The 4th Directive contains no indication of the accounting treatment to be applied and there is no distinction between a finance and operating lease. As a result of this lack of a definition, each member state gives its own interpretation as detailed in Chapter 8.

6.6.4. TRANSLATION OF FOREIGN CURRENCY.

The methods of currency translation are not dealt with in the 4th Directive although Art 43 1(1) requires that where items were translated to local currency, additional information be disclosed in the notes to the accounts. The company must report on the bases of translation used to express these items in local currency, although no fixed method need be applied. This provision is again contained in Art 34.1 of the

7th Directive. It would appear that translation methods do vary and details of these methods are given in Chapter 8.

6.7. CONCLUSION.

Unlike international accounting standards where detailed principles are provided, the 4th Directive contains few or no details. In some instances as a result of political expediency, there are options, which a member state can adopt. Even this does not harmonise accounting practice as some member states may legislate for greater control than the minimum standards set in the Directives.

Clearly the implementation of the different options allow member states to utilise them differentially and therefore when, for example, Art 47(2)(a) and (b) allows a member state to permit the publication of an abridged balance sheet and notes, this can be applied in many ways.

All this has an indirect bearing on the consolidated accounts as the 7th Directive is in many aspects dependent on the applications (or lack thereof) contained in the 4th Directive. The consolidated balance sheet and profit and loss account must be drawn up in accordance with the requirements of the Directive and therefore no adjustments can be made to the layouts in the 4th Directive other than those allowed by the 7th Directive.

6.8. AN INTRODUCTION TO THE 7TH DIRECTIVE.

A basic knowledge of accounting enables a person studying the financial statements of an undertaking or group to learn a great deal about it and to compare it with similar undertakings or groups in allied fields. There is, however, a precondition, and that is that the accounts are prepared on a uniform basis.

A multinational corporation expects the financial statements to conform either to their home standards or to some internationally recognised standard such as those issued by an EU member state or the IASC. Accounts should be prepared under generally accepted accounting principles but the issue that exists is how to establish

a worldwide standard. Differences do exist between countries and cannot be adjusted by a simple calculation. They must be understood, examined and adjusted accordingly.

The style and content of reports and accounts may vary, depending on the groups' view of the use of the report as a public relations exercise. There is still minimum information that must be disclosed in order to comply with existing law.

During the past number of years a great deal of change has taken place in financial reporting, but even so problems still exist. These include, *inter alia*, off balance sheet financing, accounting for brand names and accounting for complex capital transactions. In addition, if financial statements are to serve the users then they should try and reflect actual economic opportunities.

Prior to the adoption of the 7th Directive, consolidation could be said to have been a rarity in Europe. The dominance within continental Europe of tax legislation requirements and therefore the tax authorities and the investment by banks in the large multinational groups, were certainly major contributors to the lack of interest in consolidated accounts.

In France listed companies were not consolidated until the 1980s and in Germany, even up until 1990, there were very few companies that were consolidated and even then consolidation did not extend to foreign subsidiaries.

There are differences in the definitions of subsidiaries and associates, the calculation and write off of goodwill, treatment of joint ventures and unincorporated subsidiaries. Through the introduction of the 7th Directive (83/349/EEC of 13 June 1983), the EU has tried to harmonise the rules. Here again wide latitude, coupled with many options, is afforded to member states in their adoption of this directive.

6.9. PRINCIPLES OF THE 7TH DIRECTIVE.

The 7th Directive follows on from the 4th Directive and states in its preamble that many companies are members of groups ('bodies of undertakings') and that consolidated accounts must be drawn up so that financial information may be conveyed to members and third parties. It applies and extends the provisions of the 4th Directive to the preparation of consolidated accounts. It requires national co-ordinated legislation on consolidated accounts so as to achieve (according to the preamble), the 'objectives of comparability and equivalence in the information which companies must publish within the Community.'

It reiterates aspects of the 4th Directive and requires that consolidated accounts give a true and fair view of the assets and liabilities, the financial position and the profit and loss of all the undertakings consolidated. In general terms the 7th Directive (Art 1) states that parent undertakings must produce group accounts and they must include domestic and foreign subsidiaries irrespective of the legal form and regardless of where the registered offices of such subsidiaries are situated. The group accounts must show a true and fair view and use the formats of the 4th Directive, which can be adapted.

Many aspects of the 7th Directive have been influenced by UK accounting practice. In a case study by Diggle and Nobes (1994) on the 7th Directive, the results showed that from its origin in the late 1960s until the published drafts of the late 1970s 'it showed clear German parentage.'

The question of what constitutes a group brought into discussion the 'de jure' and 'de facto' approaches (see section 6.10 below) which led to the first of many options allowed in the Directive. The main issues considered in the 7th Directive are the group definition, the various accounting methods and how subsidiaries are accounted for and when they are excluded.

Although the intention of the 7th Directive was to introduce harmonisation into group accounting, there is still a range of options, allowing for a diversity of accounting methods. These options include:

- calculation of goodwill;
- use of merger accounting and proportional consolidation;
- exclusion of subsidiaries; and
- small company exemptions

In spite of all this there is still a large measure of harmonisation as compared to the situation that existed prior to the introduction of the 7th Directive.

6.10. DEFINITION OF A GROUP.

The existence of a parent-subsidiary relationship is determined by establishing 'de jure' control or 'de facto' control by the parent.

'De jure' control was the UK tradition where control was determined by the ownership of legal control. The German tradition of 'de facto' control is based on the exercise or the right to exercise actual control.

The 7th Directive has combined the two as seen in Article 1.1. As a consequence, consolidated accounts are required where the parent undertaking:

- (a) Has a majority of the shareholders' or members' voting rights in another undertaking (subsidiary); or
- (b) Is a member (or shareholder) and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (subsidiary); or
- (c) Has the right to exercise a dominant influence over an undertaking (subsidiary) where it is a member (or shareholder), pursuant to a control contract or provision in the memorandum and articles; or
- (d) Is a member (or shareholder) of an undertaking and:

- (aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking who have held office during the year, the previous year and up to the time of the issue of the consolidated accounts have in fact been appointed solely as a result of the exercise of its voting rights; (this could be subject to a 20% holding or more).⁷² or
- (bb) controls alone, pursuant to an agreement with other members (or shareholders) a majority of the members' (or shareholders') voting rights in the undertaking.

The option (Art 1.2) exists for consolidated accounts if the parent undertaking holds a 'participating interest' (as defined in the 4th Directive) in another undertaking (i.e. rights in the capital of the other undertaking) and

- (a) Exercises a dominant influence; or
- (b) It and the subsidiary undertaking are managed on a unified basis by the parent undertaking.

The emergence of controlled non-subsidiaries in the UK made it clear that the old definitions were too easily defeated if a company wanted to exclude other companies in the group. As a result the new definition of Article 1.1 has certain parameters common to all countries:

- Majority voting powers;
- Majority of the board;
- Dominant influence by a control contract or the memorandum;
- Control with the agreement of other shareholders.

Not all member states adopted the options in a uniform manner and this can be seen in the following instances:

⁷² This applies in France (40% or more).

- Art 1.1(c) applies in the UK and Germany in instances where the parent is not a member;
- Art 1.1(d) was not adopted in the UK; and
- Art 1.2 was not adopted in France.

6.10.1. PREPARATION OF CONSOLIDATED ACCOUNTS.

The consolidated accounts comprising the consolidated balance sheet, consolidated profit and loss and notes on the accounts must be drawn up clearly and in accordance with the 7th Directive (Art 16). They are required to give a true and fair view (Art 16.3) and must be presented in the prescribed format of the 4th Directive (Art 17).

Where tax-based values are presented in company accounts they can either be disclosed or corrected as in the case of France and Germany. In France it is possible to do the correction because the consolidated accounts are not used for tax purposes while in Germany the disclosure route is used.

Although the acquisition method (full consolidation) is used for new subsidiaries, the Directive also allows the use of merger accounting. It must be noted however that certain conditions must exist before this latter method can be used.

In acquisition accounting, unlike merger accounting, goodwill usually arises. Under the Directive, a calculation is made at the date of acquisition either on the basis of fair value of the net assets or book value. Both methods are used in France and Germany and fair value is used in the UK.

Using the book value method the difference between the cost of the subsidiary and the book value of the net assets is allocated to the assets and liabilities on a basis of fair values with any remainder being goodwill. Although negative differences are less likely to arise in this method they must be shown as reserves unless they can be written back to profit because of realisation or the occurrence of anticipated losses of the subsidiary.

Because of the 7th Directive there have been significant changes in undertakings treated as subsidiaries. In Germany there is now the need to consolidate foreign subsidiaries. Users need to be aware of the definitions and the interpretations being used and ensure that non-consolidated undertakings are taken into the financial statements.

6.10.2. EXEMPTIONS FROM THE PREPARATION OF CONSOLIDATED ACCOUNTS.

Under Art 5 an optional exemption exists in the case where the parent undertaking is a financial holding company.

Other exemptions are contained in article 7 where:

7.1(a) A parent undertaking is a subsidiary undertaking of another undertaking and is included in the consolidated accounts of another EU member state undertaking; or

7.1(b) The parent undertaking holds 90% or more of the shares in an exempted undertaking and the remaining shareholders (or members) agree to the exemption.

This can apply where the parent undertaking and/or one or more subsidiaries are companies as set out in Art 4⁷³ or it is a small group as set out in the criteria of Art 27 of 4th Directive (Art 6).

6.10.3. UNIFORM ACCOUNTING POLICIES.

Consideration must be given to the application of accounting policies in group accounts, bearing in mind that there is no need for the group accounts to utilise the same policies as those used in individual statements. While the same principles apply in all cases in the UK, in France and Germany one method may be used in the individual accounts while another could be used in the consolidated accounts.

⁷³ France - SA, SCA, SRL; Germany - AG, KG, GmbH; UK - PLC, Ltd.

In France this is not done in all cases but is becoming increasingly evident as multinationals attempt to achieve acceptance on the international capital markets and make use of US GAAP or IASs. Of the groups in the sample, 3 used US GAAP and 2 used IASs. The remaining 50% made use of French accounting standards both in their parent company accounts and the group accounts.

In Germany, while the majority of groups still adopt the same accounting principles in both individual and consolidated accounts there is a growing trend towards the use of IASs and/or US GAAP for group accounts. This was illustrated in the sample set where 4 groups made use of US GAAP⁷⁴ while an additional group- Bayer- used IASs.

Tax values need not be eliminated in consolidation and when they are there could be the disclosure of secret reserves. An example of this was in 1989 when Daimler Benz discontinued their conservative accounting policies in their consolidated accounts. This resulted ultimately in the release in 1992 of DM4.5 billion of hidden reserves.

6.10.4. EXCLUSIONS FROM CONSOLIDATION.

Although Art 13 and 14 gives reasons why undertakings may or must be excluded the individual member states are able to impose more stringent legislation as shown in Table 6.5 below.

⁷⁴ In 2 cases, that of BASF and Degussa, the groups state that they are satisfied that US GAAP is equal to German standards.

Table 6.5 Exclusions from consolidation

Reference	Not material	Severe long-term restrictions	Undue delay and/or expense	Shares held for resale	Different activities
7 th Directive	May exclude (Art 13.1)	May exclude (Art 13.3(a))	May exclude (Art 13.3(b))	May exclude (Art 13.3(c))	Must exclude if not give TFV per Art 16 (Art 14)
France	May exclude	May exclude	May exclude	May exclude	May exclude
Germany	May exclude	May exclude	May exclude	May exclude	Exclusions in Germany
United Kingdom	May exclude	FRS 2 says MUST	CA say May where not material. FRS2 says MUST NOT	FRS2 says MUST	Apply to a very restricted category of company

As a result of these exclusions which may be applied by the individual Member State, there are potential differences to the consolidated financial statements. This is brought about by the treatment of non-consolidated subsidiaries and the differences in definitions of parent-subsidiary and parent-associate relationships.

6.10.5. ASSOCIATES AND JOINT VENTURES.

As stated above, definitions of these terms are adopted in similar but not identical ways and can result in differences between member states.

Associates are where another undertaking exercises a significant influence and this is said to exist where 20% or more of the voting rights are held by it. They are shown in the consolidation by some version of the equity method. At the date of the acquisition, the associate is held either at book value (in UK) or at the group's proportion of its shareholder's funds. Goodwill is shown in the balance sheet or in the notes. Each year the group's percentage of profit is brought into the group profit

and loss account and this amount (less dividends paid out of it), is added to the holding company value of the associate.

A joint venture is created through contractual arrangements where the venture is jointly controlled and would normally be accounted for using the equity method. Proportional consolidation is also allowed in joint ventures. In the UK proportional consolidation may be allowed for unincorporated joint ventures (para 19 of Sch 4A) while in Germany it may be used and in France it must be used.

6.11. FAIR VALUE.

Fair value is placed on assets acquired, which allows for the determination of goodwill. The 7th Directive allows for some variation in the application of the fair value rules. The UK requires the full use of fair values on consolidation while in Germany companies may use the 'book value' method or the 'purchase method'. (In the sample of German groups seven indicated that they had used the book value method).

The 'book value method' involves a comparison of the value of the investment with the book value of the subsidiary assets. Any difference is eliminated by allocation to individual assets and liabilities up to their market value and by the creation of goodwill. The 'purchase method' uses fair values directly in the group accounts up to the carrying cost of the investment.

6.12. CONCLUSION.

Although the EU harmonisation effort has been regarded as a success story and has certainly been a boost to accounting harmonisation, the EC decided in November 1995 to adopt a new approach to accounting harmonisation, which they termed the New Accounting Strategy.⁷⁵

The EC stressed that there was the need for the EU to commit itself to the internationalisation process, which they considered, offered the most rapid and

⁷⁵ 'Accounting Harmonisation: A new strategy vis-à-vis international harmonisation.'

efficient solution for the problems facing companies operating in an international environment.

This process was advanced in 1996 by the examination of the degree of conformity between IASs and the EC Directives by the EC Contact Committee on the Accounting Directives. As a result of this examination the contact committee concluded that there were only two minor areas where EU rules and IASs differ. This would clearly allow companies the benefit of using IASs without being in conflict with EC Directives. As a result and possibly because of other pressures, Germany and France have subsequently made substantial changes in accepting the use of international standards in consolidation [see Chapter 7].

As these changes are relatively new, it is not yet possible to determine the take up by groups within those member states, nor to see the extent to which this has helped in the harmonisation process. Chapter 8 does however examine groups in specific areas and these may give some guidance to the process.

Subsequent to this the EC announced that it will bring forward proposals before the end of 2000 which would require all listed EU companies to prepare consolidated accounts in accordance with IASs.

CHAPTER 7

A REVIEW OF ACCOUNTING IN FRANCE, GERMANY AND THE UNITED KINGDOM.

7.1. INTRODUCTION.

The accounting practices of national companies are best understood within the context of the environment in which each company operates. This was argued by Mueller (1968) and Radebaugh (1975). Accounting methods and numbers do not always (or ever) give the full story on the company's financial position. The aim of this chapter is to give a broad view of the business and accounting regulatory environments of the three countries covered. In doing so it will act as a basis for appreciating some aspects of their accounting measurement and disclosure practices. In addition the chapter will give a brief overview of the accounting practices used by each of the three countries on the selected topics.

7.2. FRANCE.

France with an industrial economy has many different types of business enterprises, the main ones being the SA and SARL (see 7.2.2). There are also many small and medium sized businesses. Funding is traditionally from banks and the state and so there is a greater reliance on that source rather than the share market. There has however been an expansion of stock exchange activities encouraged in part by the government (see 7.2.8). Change has taken place over the past decade, most importantly the rapid change in accounting regulation and reporting standards as witnessed in the past few years.

7.2.1. LEGAL SYSTEM.

French law is based on a codified (Roman law) system and includes the Commercial Codes and related Decrees. As a result all rules for accounting and financial reporting are dealt with in these laws although not all entities are subject to the same legal requirements. All commercial transactions are subject to the

application of commercial law while non-commercial transactions are dealt with by civil law. The law or act of parliament (*loi*) is the paramount authority with decrees (*decret*), government orders (*ordonnance*) and ministerial orders (*arrete*) having different priorities.

The regulatory and legislative sources of company law are the *Code de commerce et la loi sur les sociétés commerciales* (Commercial Code- Code) and the *Plan Comptable Général* (PCG). Although no guide to accounting is given in the civil law, the legislation has a significant influence reflecting the national planning policy of the government and the high level of standardised accounting practice and reporting. This is aided by the use of the PCG, which originated in 1942 (see 7.2.1.2).

Only the Government is empowered to issue legally binding accounting *normes* (i.e. something between a standard and a rule), although it does consult with other bodies such as the *Conseil National de la Comptabilité* (National Accounting Council - CNC).

7.2.1.1. COMMERCIAL CODE.

Modified to implement the 4th Directive,⁷⁶ the code constitutes the general framework of accounting for all commercial entities and persons independent of their legal form – *commerçants*.⁷⁷ It contains generally accepted accounting principles, which are detailed in Articles 8 to 17 of the Code.

The code does not refer to the PCG and although the PCG fits into the structure of commercial law, it is not itself a law in regard to its own details. It could rather be regarded as a form of an accounting manual.

⁷⁶ The code was amended by loi 83-353 (30 April 1983) with the decret 83-1020 (29 November 1983) and was to apply for all years after 31 December 1983

⁷⁷ As the 4th Directive was only directed at incorporated companies, the ambit of the code was much wider.

7.2.1.2. *THE PLAN COMPTABLE GÉNÉRAL.*

The PCG was first published in 1942 although there were accounting plans before that date.⁷⁸ The idea for the PCG originated from a proposal of Eugen Schmalenbach, which was adopted in Germany in 1937. The PCG, through the influence of German accounting practices, reflects as its main principle conservatism and adherence to legal form rather than economic substance.

The Vichy government started a project for developing a national accounting code. This was presented to the government in 1942 and, although published in 1943, was not applied as the authority of the Vichy government was swept aside and conditions did not allow for any change.

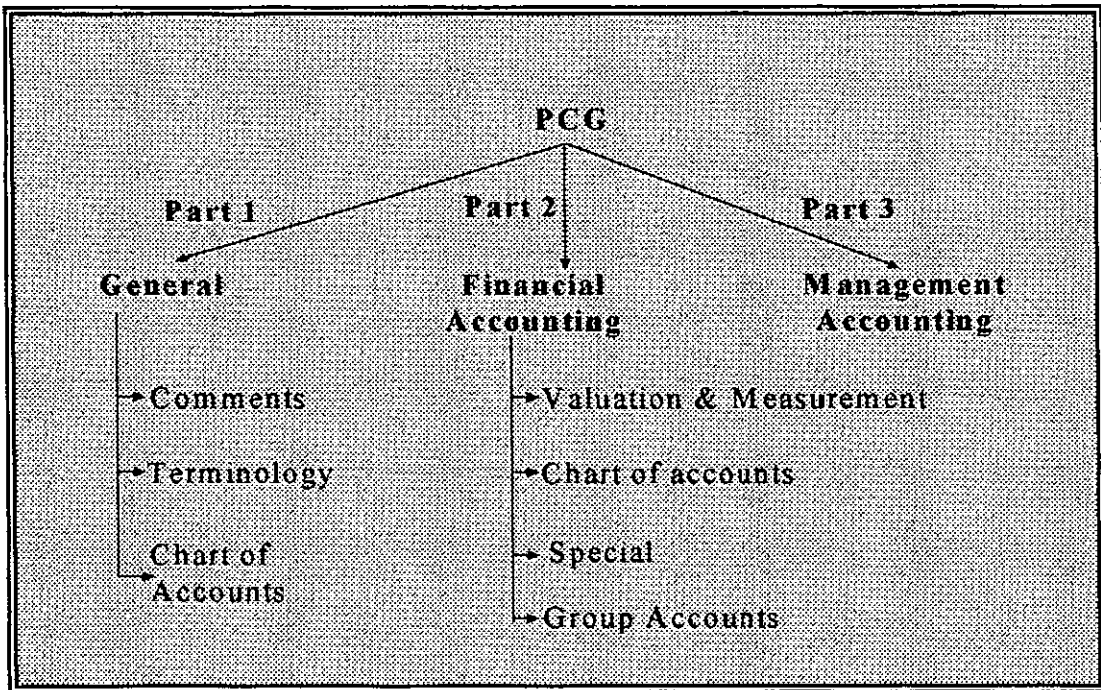
When finally published, the PCG was the only form of accounting standardisation and although it applied to all categories of French enterprise⁷⁹ it was not mandatory. The main objective of the PCG was to allow the government to gather data for planning and controlling the economy by standardising financial reporting formats. It was through the use of the PCG that France pursued accounting harmonisation.

The PCG is essentially a chart of accounts providing a system of ledger codes with instructions and guidelines and a standard format for an annual statement together with the notes to the accounts [see Fig 4].

⁷⁸ A standardised accounting code was developed in Germany and approved there in 1937 by Hermann Goering as it was seen to be a convenient national instrument of control. It was to contain the regulations for bookkeeping principles (GoB) and was known as the Goering plan. This plan was not preserved through legislation by Germany after the war.

⁷⁹ The plan applied to the public sector, nationalised undertakings and to enterprises receiving significant public subsidies (Standish, 1990, p.350).

Figure 4 The subdivisions of the PCG



It provides a detailed accounting guide and overall standardisation for the compilation of national accounting statistics as well as information on rules of valuation, general accounting principles, group accounts and cost accounting (see Table 7.1).

Table 7.1 A summary of the composition of the PCG

- Statement of general accounting principles
- Arrangements for the organisation of accounting
- Rules for valuation and measurement of operating results
- A standardised chart of accounts
- Instructions and guidelines for usage of accounts within the chart
- Standard format for financial statements and notes on the accounts

The chart of accounts uses a decimal numbering basis and divides accounts into various classes (see Table 7.2). Companies, tax authorities and others responsible

for the preparation of accounts strictly comply with the terminology and numbering of ledger accounts.

Table 7.2 A summary of the account structure within the PCG.

Item	Class headings
Balance sheet	1-5
Operating accounts	6-7
Special accounts (e.g. leases)	8
Cost accounts (optional)	9

The PCG was revised in 1957 and in 1965 it was made obligatory (there was still no provision for prosecution for non-compliance). This was as a result of a tax decree, which required companies to file tax returns, based on the formats of the PCG.⁸⁰

All this meant that industrial and commercial enterprises, whether incorporated or unincorporated, had to arrange their accounting and bookkeeping in conformity with the PCG. Departures could only be made when they were justified because of special activities or because of the structure of the enterprise. (The PCG has three levels of application depending on the size of the enterprise, so that although the PCG is a national accounting code it is adapted to different sectors, for example, commercial or public sector).

Prior to 1965 neither Tax nor Company Law contained any accounting rules, nor did the accounting authorities issue any accounting standards. These standards were the task of the CNC who formulated them and implemented them through the PCG. The PCG is maintained by the CNC⁸¹ (see 7.1.4) but that body had very limited

⁸⁰ This was the first time that tax law referred to accounting principles and the PCG. Art. 38 of the law states that it recognises the PCG but that if the rules are in conflict with tax law then tax law is used. Mikol (1994) reported that the PCG is only a decree while tax law is law.

⁸¹ The CNC issued guidance on the interpretation of the PCG while the OEC issued technical guidance. Neither body had any statutory rights. As such there was a low compliance rate.

legal authority. It is considered by Scheid (1993) that the PCG could 'become more authoritative, requiring expression in legal form. Alternatively it could be developed as a technical support in the nature of a manual.'

Further revisions of the PCG were made in 1982 in order to incorporate the requirements of the 4th Directive with additional modifications in 1986 when the 7th Directive was implemented. The 1982 PCG introduced concepts such as the true and fair view and other provisions of the 4th Directive while the 1986 amendments dealt with consolidated accounts and accounting for deferred taxation and currency translation of foreign subsidiaries.

A further revision was developed in 1997-98 and this was substantively approved by the CNC in December 1998. In 1999 the CRC (see 7.2.4) approved the changes which were then adopted under ministerial regulation. These changes included amended rules for valuation and the measurement of operating results.

The PCG was generally adopted because of several factors:

- A 1959 Law to adapt the PCG to the needs of each industry;
- the use of the PCG to train accountants; and
- the 1965 tax decree detailed above, which aligned the income tax declarations with the PCG and its formats.

By the 1970s the PCG was the standard basis for accounting and reporting although it did not cover the aspects of consolidation. It was not until the revision in 1982 that the PCG became more international in outlook and reflected the exposure of the French economy to international influences and capital movements.

In many cases there is duplication between the laws and the PCG although the latter is more detailed as, for example, where it gives a list of accounts. In summary it can be said that the PCG has been largely replaced by laws such as company law and that tax laws compete with it as a source of authority.

7.2.2. FORMS OF OWNERSHIP.

There are five legal forms and the Commercial Code⁸² applies to all of them. Within these forms it should be noted that companies could either be of a civil or a commercial nature. In the case of the latter they are usually engaged in a trade or business.

The legal forms are:

- *Société Anonyme* (SA) (public limited liability company with shares) with a minimum of 7 shareholders and a minimum capital of 250,000 FFr or 1.5m FFr if a quoted company.
- *Société à Responsabilité Limitée* (SARL) (private limited liability company). This is a company with between one⁸³ and a maximum of 50 shareholders and a minimum capital of 50,000 FFr. Small companies are not required to appoint a statutory auditor.
- *Société en Commandite par actions* (SCA) (limited partnership, which also has a number of partners whose liability is unlimited). This legal form is rare but is used by, for example, EuroDisney and Michelin.
- *Société en Nom Collectif* (SNC) (partnership with unlimited liability). This legal form is often used by small family-owned firms and is frequently chosen for tax reasons as the vehicle for joint ventures between large companies.
- *Société en Commandite Simple* (SCS) consists of limited partners who cannot sell their interest without the approval of all limited partners.

Of the commercial companies described above the first three forms can be described as joint stock companies (*Sociétés de Capitaux*) while the latter two are partnerships (*Sociétés de Personnes*) although they are still classed as separate legal entities.

⁸² Established by *loi* 66-537 (24 July 1966) and *decret* 67-236 (23 March 1967).

⁸³ Termed as an *Entreprise Unipersonnelle à Responsabilité Limitée* – EURL.

There are additional forms but these fall outside the regulations of the Commercial Code. The most important is the *Société Civile* (SC) which is a cross between a partnership and a limited company and normally does not have commercial objectives (it usually specialises in a few activities such as building or the professions) and an *Établissement Public à activité* (EPIC) e.g. SNCF and Renault.⁸⁴

7.2.3. HISTORY OF FINANCIAL REPORTING IN FRANCE.

Commercial law relating to accounting in France dates back to the *Ordonnance* of 1673. At that time Louis XIV, acting on the advice of Colbert, issued an order regulating the *société générale* and the *société de command*, forms which are similar to the present SNC and the SCA respectively, through detailed bookkeeping regulations (Commercial Code). Jacques Savary redrafted the *Ordonnance De Commerce* in a more accessible form entitled *Le Parfait Négociant* in 1675. The redraft included a commentary with examples and interpretations.

In 1807 under Napoleon I this law was incorporated into the Napoleonic Code de Commerce. The Code de Commerce was drawn up regulating SAs, SCAs and SNCs while in 1863 SARL law (amended in 1925) was promulgated. It was a major part of the *Code Napoléon* and required all traders to keep accounts. Reform of the law was not activated until the need to adopt the 4th Directive was incorporated in the accounting law of 1983.

Prior to 1983 the requirements for keeping accounts were not specified although by the law of 24 July 1966, companies were required to keep more extensive accounts. Company law had a major revision in 1966 where the following were brought about:

- A revised audit function.
- A list of information to be included in the annual report.

⁸⁴ 'Les Affaires En France -Doing Business in France', Groupe France Audit SA, Paris, pp.10-15.

- A defined form and details for the content of the balance sheet and profit and loss account.

The same law together with the Decree of 23 March 1967 sets out consolidation rules, publication rules, audit requirements and other information for commercial enterprises.

Accounting developed as an extension of the law and inherited its codified structure and its rigidities. Accounting principles reflected interests in both tax collecting and economic planning and are a key feature of French accounting.

French industry consisted of small and medium privately owned companies, often family businesses. Only later banks and subsequently the state, through nationalisation, became a major source of finance. The small companies were not too complex to manage and therefore there was little need for comprehensive accounting procedures.

While accounting developed up to World War II the priority of the country at the end of the war was on reconstruction. There was a need for the efficient use of resources and the control of progress. This saw the need for larger scale commercial and industrial organisations brought about through nationalisation and government investment in the business sector. At the same time the government introduced industrial and economic planning and with it the additional need for reliable and adequate data. This was the driving force in the adoption and subsequent extension of the PCG.

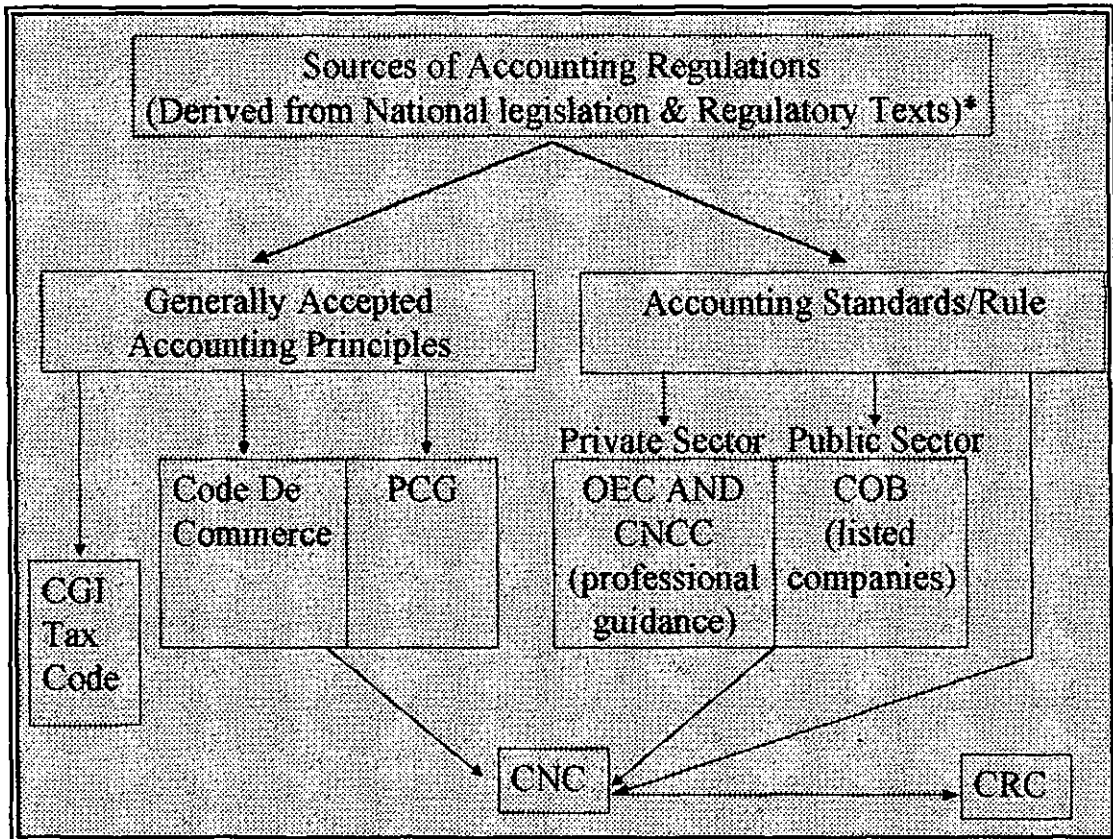
During the 1960s and 1970s French business became more multinational in character. Firms, even family firms, recognised that there was a need for the disclosure of information to outsiders. Even though tax was the determining factor in accounting preparation, detailed disclosure even if through the preparation of a second account, was also being practised.

With entry into the EU, industry became exposed to international competition. The change in character of French business required more international accounting to assist enterprises in raising finance on the international markets..

Accounting principles conforming to the requirements of the 4th and 7th Directives were incorporated into law by Acts of Parliament. The 4th Directive was implemented by the Law of 30 April 1983 and the Decree of 29 November 1983 and the 7th Directive was implemented by the Law of 3 January 1985 and the Decree of 17 February 1986.

These laws applied not only to companies but also to unincorporated enterprises. This ensures that annual financial statements conform to the principles laid down by law in the Commercial Code and that the basic concepts of prudence, going concern and consistency have legal force.

Figure 5 The source of accounting standards



*Supplemented and clarified by authoritative pronouncements.

7.2.4. REGULATORY BODIES.

The existence of a complex web of legislation or quasi-legislation does not imply that the companies are complying with it. France with a modern capital market requires an active supervisory body to promote competitive multinational businesses. Standards of reporting and disclosure need be kept at a higher level than in earlier years where profit smoothing, inconsistency and minimal disclosures were common. There are a number of bodies responsible for issuing recommendations on accounting matters and while some are purely regulatory others can be classed as professional bodies.

The regulatory bodies responsible are:

Conseil National de la Comptabilité (National Accounting Council - CNC). This body was first established as the Accounting Standardisation Commission and given the task of creating the first accounting plan. It was dissolved in 1947 and replaced by a 'Higher Council for Accounting' whose task it was to formulate adapted plans for various sectors of the economy and to prepare a new PCG. The government in 1957 subsequently approved this new PCG and the Higher Council then by decree, became the CNC.

The CNC is a consultative body created to co-ordinate and integrate accounting practice. It developed and adapted the PCG and issued generally accepted rules as recommendations that, although not binding on companies, helped develop accounting principles. The CNC is composed of accountants, representatives of industry, banks and the COB and is attached to the Ministry for the Economy and Finance.

In 1971 the CNC worked on a revision of the PCG which it completed and had approved in 1982. The revised PCG was to apply for all years commencing after 31 December 1983 and became mandatory for all enterprises.

In 1993, a decree⁸⁵ changed the composition and tasks of the CNC. This was followed in 1996 by a major reform to the French accounting system. This reform reduced the size of the committee and increased the non- public sector representation. The CNC now has 58 members (a decrease from the 103 of 1992), of which 13 are from the public sector and 45 from the non-public sector.

This resulted in the CNC restating its mission as being to provide rulings and recommendations on accounting issues across all economic sectors thus giving it formal control of the accounting setting process. The CNC created the *Comité d'Urgence* (Urgent Issues Committee - CU) to deal with the interpretation or application of accounting standards and to give rulings within a limited period. In

⁸⁵ 93-167 of 1 February 1993.

1998 this committee issued 5 rulings covering topics from accounting for deferred charges to accounting for the consequences of the transition to the euro.

A *Comité de la Réglementation Comptable* (Accounting Regulatory Committee - CRC) was formed in 1998⁸⁶ to convert CNC rulings into regulations. The CRC was given regulatory powers and provides a flexible way for regulating accounting standards. It brings together representatives of state departments and the judiciary (8 members) with private sector representatives (7 members). This marks a new process for giving regulatory effect to the PCG.

The CRC also regulates the accounting principles used by listed companies in the consolidated accounts and permits the use of international accounting standards. In the absence of an agreed body of international standards, listed companies can, until the end of 2002, prepare consolidated accounts using any set of internationally recognised standards. The only proviso is that the standards used have been translated into French and are in conformity with the EC Directives and French law.

The effect of the 1998 company law amendment is that companies may use IASC standards (available in French) whose standards comply with EC Directives and French law. It is unlikely that they will be able to use US GAAP, as it is not translated. This means that it is legally impossible for French companies to continue reporting on that basis.⁸⁷

Commission des Opérateurs de Bourse (National Securities Commission - COB) is an independent administrative and regulatory authority that protects investors, supervises financial reporting and oversees the Stock Exchange. It was created in 1967 and canvassed for better accounting and greater disclosure. The COB monitors information submitted by companies and is able to intervene by making rules and recommendations. It can give advice, hold enquiries, verify accounts and levy fines. It has the ability to impose new accounting rules on listed companies

⁸⁶ By Law 98-261 of 6 April 1998.

⁸⁷ This was reported on by Standish (1999) in a joint publication for the OEC and CNCC, p.15.

even though those rules are not contained in any law or regulation. In this way the COB participates in the development of accounting principles. It publishes recommendations and opinions to encourage public companies and auditors to adopt sound accounting and auditing practices.

Within the COB, regulation and organisation is the responsibility of the *Conseil des Bourses de Valeurs* (CBV) while the *Société des Bourses Françaises* (SBF) examines listing applications submitted to the CBV.

Although the COB does not regulate company disclosure directly, it has wide-ranging powers from legislation in 1989 and 1996, which exceed those of the CNC. The latter are not able to apply accounting standards to quoted companies other than by ministerial regulation. The COB on the other hand is authorised to issue accounting rules in its own right even without consulting the CNC. (This is similar to the SEC, which leaves standard setting in the US to the FASB).

7.2.5. PROFESSIONAL BODIES.

Although the advent of the auditor (*Commissaire aux Comptes*) dates back to 1867, the accounting profession was established after World War II when the government needed to standardise the ways of financial reporting and auditing. It differed from the UK, for example, where it was the profession that made the decision ahead of the government's attempts to regulate reporting. The auditor has always been regarded as separate to the accountant as a professional, although nearly all auditors are members of the accounting body.

There are two professional bodies responsible for the regulation of accounting and auditing in France. Both have been active in the sphere of international accounting harmonisation either as a founder member of IASC or of international auditing standards through participation in IFAC.

In 1945 the government created the *Ordre des Experts Comptables et des Comptables Agréés* (OECCA). This was changed in 1991 to *Ordre des Experts Comptables* (National Institute of Public Accountants -OEC). All accounting

regulations fall under the Ministry for the Economy. The OEC does not set standards but issues recommendations, guidelines and interpretations to companies on how to apply the various rules and in addition, it also issues auditing guidelines. All these recommendations and guidelines lack the force of law. While members are allowed to undertake audits they may not act as statutory auditors.

There is a misconception that French accounting is heavily controlled by the state. The major state impact on accounting has been through tax legislation and the requirement that all expenses claimed for tax purposes should be reflected in the accounts. State intervention is designed to promote and protect industry by providing grants for research and development and accelerated tax allowances.

The statutory auditor is a member of the *Compagnie Nationale des Commissaires aux Comptes* (National Institute of Statutory Auditors - CNCC) formed in 1969, which issues audit standards and guidelines and is under the control of the Ministry of Justice. It gives advice and issues legal comments to members and publishes professional standards and guidelines. It gives opinion on due diligence and its standards are equivalent to the international auditing standards of IFAC. Although the CNCC is a separate body from the OEC almost all statutory auditors are also members of the latter.

While OEC members are more involved with opinion (non-statutory) audits (for COB or large French companies looking for international finance), the CNCC auditor ensures that the law is complied with. This is re-enforced by the fact that CNCC is supervised by the Ministry of Justice and the OEC by the Ministry of Finance. The role of the statutory auditor in France has been one that highlights their audit independence and objectivity.

Auditing has been in existence in France for over 100 years and evidence of this is that the word *commissaire* appeared for the first time in French statutes in the law of 23 May 1863. From 1966 the Code required that all SAs and SCAs appoint independent auditors to ensure that the annual financial statements were properly prepared and complied with the true and fair view.

Verification of the assets of the company and the information given by directors was required from 1935 where official auditors were appointed by the regional courts. At that time they certified the *regularité* of the accounts (conforming to legal requirements) and their *sincerité* (good faith i.e. application of accepted valuations)

The role of the auditor was the checking of compliance with the law. There was no need at the time to consider the quality of the economic information for the shareholder. If there were any breaches of law then there was a statutory duty by the auditor to report these to the state prosecutor. In 1984 the 4th Directive was implemented and on 1 March 1984 the audit requirement was extended to all enterprises classified as medium or large enterprises.

Besides the requirements of the SA and SARL in the Directive, the accounting and auditing requirements also apply to all 'commercial' entities and non-commercial ones (SCSs and SNCs) that meet any two of the three criteria at year end as set out in Table 7.3 and Table 7.4.

Table 7.3 Determination of a large company.

Total assets	Total turnover	Average number of employees
In excess of FFr 10m	In excess of FFr 20m	50

Table 7.4 Determination of the small company.

Total assets	Total turnover	Average number of employees
Less than FFr 1.75m	Less than FFr 3.5m	10

The concessions granted allow a small company to prepare an abbreviated balance sheet and profit and loss account but gives no allowance for a director's report. In France there is no option provided for distinguishing medium-sized companies.

When consolidated financial statements are required, then two independent auditors must be appointed although this only applies if the group meets certain criteria as set out in 7.2.7.

In order to ensure that auditors are truly independent, French legislation provides that although audit firms are permitted to form limited companies, they may not undertake an audit if they act as the accountant to a particular client. The specification of conditions for audit independence and objectivity are important. Two major task forces under the chairmanship of Yves Le Portz have addressed these issues in 1992 and 1997. The recommendations of audit supervision and quality control made by these task forces are fully supported by the CNCC and COB.

7.2.6. THE TAX SYSTEM.

The French tax system is an imputation system similar to that of the UK. It has a strong influence on French accounting practice (tax laws override accounting rules) especially valuations, with the tax administration often setting the lead in accounting matters over decisions of the CNC. For example, there is an annual review of balance sheet values against current values, which leads to additional write-downs of assets.

Prior to 1965 tax law determined the method of accounting because company law contained no regulations on the balance sheet and profit and loss account and according to Schneid (1993) because of the weakness of the profession. There was no formal link between commercial and tax accounting. In 1965 this changed with the adoption of the standard format annual tax return which followed the structure of the PCG (see 7.2.1.2). The tax code (*Code General des Impots* - CGI) says 'business should follow the definitions set out in the PCG, provided that these are not incompatible with the rules applicable to the calculation of taxable profit.' The objective was that taxable income and expenditure should be treated in the same way in commercial accounts and for tax purposes.

The major state impact on accounting has been through the impact of taxation where all expenses must be shown in the financial statements if they are to be claimed for tax purposes. Frylander and Pharm (1996) concluded that accounting income and tax income are measured on the same basis.

Although there is a direct link between accounting profit and tax profit, tax law often has accounting policies that differ from those set out in the PCG⁸⁸ and this has had a major impact on French accounting concepts. Examples are where tax and not economic depreciation is used, (although low value fixed assets of under FFr 2500 may be written off as an expense), and in the prudent approach to income. Assets are only revalued in line with tax regulations or legal revaluations although voluntary revaluations are permitted, but unlikely, as tax is payable on unrealised profits. Additionally, tax incentives are used and so there is a further departure from economic measurement. According to Mikol (1995), the profit as determined from the application of accounting rules is used and from that the tax profit is calculated.

Provisions for risks and expenses must be shown in order to claim them for tax purposes. When the actual expense is incurred then it is written off in the profit and loss account and the provision is reversed. It is also possible to have regulated provisions (*provisions réglementées*) which are temporary tax-free reserves within equity. Examples are the amortisation of goodwill or the creation of tax provisions.

While individual company accounts serve as a basis for the determination of taxes and tax rules dictate its usage, this does not apply to consolidated accounts. As a result the consolidated accounts could therefore use more capital market orientated rules and, therefore, for example, could restate individual figures. Although some French multinational companies may be influenced by external national financial reporting requirements, in general they report in a fairly uniform manner in line with detailed legislative requirements.

⁸⁸ According to Frylander and Pharm (1996) tax benefits can only be used where the accounting income is measured on the same basis.

Since the adoption of the 4th Directive the intended linkage is less rigid according to a publication in 1999 by the CNCC and OEC. The courts are less inclined to give primacy to tax law where an issue in dispute turns more on accounting principles.

7.2.7. **CONSOLIDATED ACCOUNTS.**

The annual report of a group contains:

1. Parent company accounts as required under the 4th Directive and the 1983 Accounting Act;
2. Group accounts as required by the 7th Directive and using one of three different bases as discussed below.

Following on the above, consolidated accounts comprise a profit and loss account, balance sheet, changes in shareholder's equity (a voluntary disclosure) and changes in the financial position (another voluntary disclosure).⁸⁹ The publication of a cash flow statement, favoured by the OEC and COB, is not obligatory and consequently there is no standard format. In fact the PCG retains a schedule for the presentation of a sources and uses of funds statement. While the CNC recommends this table of the sources and uses of funds (*tableau de financement*), many multinational groups have moved to the presentation of a cash flow statement and use the format of IAS 7 or US GAAP.

Current development is towards a more uniform approach and accounts do not necessarily comply with one set of rules. The CRC has statutory status and has reduced the options of companies in the principles they use in consolidated accounts. Through this there is clear authority for accounting rules and therefore the choice of accounting principles that can be used by companies in their group accounts is reduced.

In the late 1960s and early 1970s consolidated accounts were prepared using a wide range of accounting policies. Companies prepared accounts on a voluntary basis

⁸⁹ Many French companies and nearly all listed companies have some form of funds flow.

and adapted accounting principles that seemed useful to them.⁹⁰ In 1971 the COB made consolidation a requirement for inclusion in a company's prospectus and from 1973 it required that the accounts had to be audited.

The implementation of the 7th Directive⁹¹ required listed companies to produce consolidated accounts from 1986 and unlisted companies from 1990. Although individual accounts had to show all deductions for tax purposes the consolidated accounts were freed from these strictures and groups were free to restate individual figures and so eliminate any distortions in the consolidated accounts.⁹² In a number of areas French practice in consolidation is becoming more Anglo-Saxon (substance over form) although certain basic principles recognised by the IASC are not included in French law.⁹³

As a result of its implementation, the Code was changed accordingly and the PCG was adapted by *arrete* (9 December 1986) to reflect the new provisions on consolidation and to insert the *méthodologie relative aux comptes consolidés* (rules for consolidated statements).

Since 1986 a majority of companies have been using these rules although it is possible to use rules acceptable in other financial markets. The rules specify that a group must include all subsidiaries if the parent has exclusive control. This is defined as:

- Where the parent directly or indirectly holds a majority controlling interest (de jure control); or
- where the parent has voting power of 40% of the votes if no other shareholder or partner holds a higher percentage (de facto control); or

⁹⁰ Companies listed on the NYSE use US GAAP while those listed elsewhere especially London use IASs.

⁹¹ By *loi* 85-11 of 3 January 1985 and revised by *loi* 85-1321 of 14 December 1985 and *decret* 86-221 of 17 February 1986 and amended by *decret* 90-72 of 17 January 1990.

⁹² Accounting rules require charges in individual company accounts for tax purposes to be reversed in group accounts.

⁹³ An example is where leases are accounted for in their legal form rather than their substance.

- where a controlling influence through a management agreement exists.

In the above illustration the group accounts would be prepared on a line-by-line basis using the purchase method.

If the activities are significantly different from the parent then that company may be excluded and accounted for by the equity method although this is not widely used. Where the subsidiaries are not significant, they too can be excluded. Where the interest is more than 20% then those associates are accounted for under the equity method. Joint ventures are proportionally consolidated using an option in the 7th Directive, which is obligatory for shared control in France although its use is very rare.

Where there are partners or a limited number of shareholders as for example in a joint venture, then use is made of proportional consolidation. Where it is purely an investment then the equity method is used.

Consolidated accounts are now more stock market / shareholder orientated as explained previously. The treatment of various accounting practices differs when dealing with group accounts. For example, replacement values are shown; leases are capitalised and foreign currency gains and losses on debtors and creditors transactions are shown in the profit and loss account and not in the balance sheet. Another important treatment is that tax values shown in the individual accounts are corrected in the group accounts and not simply shown as notes to the accounts. This also means that deferred tax is recognised in the group accounts.

Where groups do not exceed any two of the following criteria then they are not obliged to present consolidated accounts:

Table 7.5 Criteria for consolidation

Total group assets	Total group sales	Average number of employees
Exceeds FFr 100m	Exceeds FFr 200m	Exceeds 500

Where companies are quoted in another country they are able to produce group accounts using the GAAP of that particular country and do not need to prepare French GAAP accounts.⁹⁴

In a survey of 100 major French listed companies (released in 1998) the increasing use of US GAAP was apparent. Details of the survey are shown in Table 7.6 below.

Table 7.6 Selection by major French groups of accounting standards for consolidation of accounts.

	1990	1996	1997
IASC	21	21	21
US GAAP	8	13	14
International practices	6	5	4
Total foreign	35	39	39
French only	65	61	61

Source: Developments in French Accounting and Auditing (1998, p.37).

This result is confirmed by this thesis where the majority of companies examined are shown to be using US GAAP.

Group accounts can be said to be prepared on one of the following three bases:

1. The same measurement rules as individual accounts which includes, for example, tax depreciation.
2. Using options within French GAAP to restate figures and eliminate tax rules.
3. Using allowed international standards such as international accounting standards.

⁹⁴ Examples are Legrand and PSA Peugeot, which prepare group accounts, based on US GAAP, while Erindinia and Lafarge use international accounting standards.

The above led to accounts that were considered not reliable, many having different accounting standards. The government tightened up the rules for consolidation in the 1990s. In part this was the modification of the CNC in 1996 when the president was no longer required to be a government official and so allowed the accounting profession to become more influential. It allowed the CU to give short-term guidance on emerging issues.

All this culminated in the French law being changed in 1998 enabling listed French groups to depart from the French rules so as to comply with international standards (details of the conditions are dealt with earlier in this chapter).

7.2.8. FINANCE.

France traditionally is a country of family-owned companies, which borrow money rather than use equity funding. As a consequence banks do not take the same direct interest in these companies as they do in Germany. The stock exchange is very active with an ongoing trend of companies switching from bank borrowing to the bond market. This is shown by the many companies who, while not listing their shares on the stock exchange, do have their bonds quoted. By 1998 the bond market showed a capitalisation of FFr 4987 billions.

Over the past three years the capitalisation of the French stock market has nearly doubled with market capitalisation of equities increasing from FFr 3078 billions in 1996 to FFr 5503 billions in 1998. Paris according to the 1998 COB annual report is now ranked as the 4th or 5th largest market world-wide. In part this could be accounted for by the fact that since 1993 the state's holdings in companies have been reduced through the privatisation programme. Examples of this are seen with groups such as Elf Aquitaine, France Telecom and Rhone Poulenc. This, together with the move to 'globalise' family companies, has now had the effect of introducing these large companies to the stock exchange (see Table 7.7 and Table 7.8).

Table 7.7 Details of new listings and capitalisation values on French stock exchange

	No. of Companies	Capitalisation (FFr m.)
Premier Market	10	68053
Second Market	77	4866
New Market	43	3471
Total	130	78390

Source: 31st Annual Report by COB, 1998.

Table 7.8 Development of securities market showing number of companies

Market	1993	1994	1995	1996	1997	1998
Premier	472	459	444	406	376	345
Second	254	265	266	280	308	368
New	-	-	-	18	38	81
Total	726	724	710	704	722	794

Source: 31st Annual Report by COB, 1998.

Company shares, most of which are in bearer form, are divided into ordinary shares (*actions ordinaires*), preferred shares (*actions preferentielles*), non-voting preference shares (*actions a dividendes prioritaires*), investment certificates (*certificats d'investissements*)(shares with no voting rights) and participation bonds (*titres participatifs*) (earn share of profits).

Nationalised industries⁹⁵ are not able to raise funds via equity funding because of the state's control and so borrow funds on the public market. They are frequent and major issuers of bonds, which illustrates why there are more bonds than shares in issue.

⁹⁵ These include companies such as : Air France, Bull Computers, Electricite dc France, Renault and SNCF.

The increase is done through investment certificates and participation bonds. The latter two have the characteristics of equity but do not carry any ownership rights as in these cases the company is state controlled.

Companies listed in France are supervised by the COB. The stock exchange is organised as set out in Table 7.9 below.

Table 7.9 The French Markets

Premier Marché	Second Marché	Nouveau Marché
Premier Market	Second Market	New Market
Large companies	Medium to Small companies	Start-up and relatively young companies

7.2.9. CONCLUSION.

France has always been a major participant in the IASC and as a result, international standards do have a major influence on current regulation and accounting practice in the areas of foreign currency translation, leasing, etc. The standardised accounting created through the PCG can change through pressure from the multinational companies and the international accounting firms.

While the individual accounts are prepared to conform to taxation requirements, group accounts show a diversity of practices, which take into account the needs of foreign stock exchanges and investors. Since the adoption of the 4th and 7th Directives, French accounting has become more international and many companies now look to the foreign capital markets for funds.

1999 witnessed many changes in French accounting and the continued movement towards the globalisation of French companies together with their adoption of an international accounting standard.

7.3. GERMANY.

Germany has an industrial economy and is heavily dependent on the activities of its companies. Major company forms are the GmbH and AG. Banks exercise a significant influence in the financial system and provide both a large part of the capital needs of industry as well as a complete range of financial services.

7.3.1. LEGAL SYSTEM.

While accounting regulation in Germany is controlled by Government Ministries it is strongly influenced by tax considerations. A legalistic mode attempting to cover all eventualities was developed in the 19th century (Gallhofer, 1989). The *Handelsgesetzbuch* (Commercial Code- HGB) of 1885, *Aktiengesetz* (Stock Corporation Law- AktG) of 1965, *GmbH- Gesetz* (Limited Liability Companies Law -GmbHG) and *Grundsätze ordnungsmässiger Buchführung* (Principles of Proper Bookkeeping- GoB) have rigid regulations relating to accounting principles, valuation rules, income measurement and the format and content of accounts.

The AktG has accounting provisions preventing the overstatement of net assets and income. These provisions include valuation rules and set out the form and content of accounts. As such accountants have little room to exercise their own judgement and must follow the legal requirements. Added to this, a lack of options ensures that rigidity is maintained.

Prior to the implementation of the Accounting Directives Law (see 7.3.1.1) answers to an accounting question had to be looked for in the special law relating to that legal form and in the uncodified accounting principles. The following procedure is now not only operative, but also obligatory:

- Review the general rules in the Third Book of the HGB.
- Review the specific provisions for companies in the HGB.
- Review any special laws for a specific entity (as, for example, the AktG).

The layout of the third book, which includes regulations for all forms of business, is in three sections. These are:

- First Section (§ 238- § 263).

This applies to all legal forms and types of business and includes a company or partnership.

- Second Section (§ 264- § 335).

This section is only applicable to companies and contains additional rules for AGs, KGaAs and GmbHs.

- Third Section (§ 336- § 339).

This section incorporates additional regulations for registered co-operatives.

With all these codified laws the question of the ability of the auditor using discretion and making judgement calls must be considered. While the dominant opinion in Germany is that compliance with the legal requirements ensures a true and fair view even if the law allows exceptions from GAAP, e.g. the creation of hidden reserves, this does not allow flexibility of interpretation by the statutory auditor. The general rule of accounting is referred to if doubt arises in the interpretation and application of individual rules or if there are uncertainties in the legal provisions.

7.3.1.1. E.C. DIRECTIVES.

With the adoption of the 4th, 7th and 8th Directives through the promulgation of the Accounting Directives Law in December 1985, and its coming into effect on 1 January 1986, there was a resultant changing in regulatory systems regarding the preparation, publication and auditing of single and group accounts. The law was a modification of 39 separate laws, the most important being a revision of the HGB. The Law became effective for the financial years commencing after 31 December 1986 for single companies and for groups after 31 December 1989, although there were many exceptions and transitional rules.⁹⁶ The Accounting Directives Law took

⁹⁶ Article 23 of the Accounting Directives Law.

into account developments of GAAP, extended the existing law to other forms of businesses and revised the HGB with the introduction of a Third Book (*Drittes buch. Handelsbücher*) setting out the accounting and auditing rules applicable to all businesses. Every businessman is required to maintain books of account and record all transactions and the financial position in accordance with GoB.⁹⁷ With the adoption of the 4th Directive into the HGB, German GAAP was codified into German Company law for the first time. Under the May 1998 amendments, the audit report in addition to the true and fair view previously expressed, must set out a description of the audit and the extent of the work performed and if there are any risks that could affect the company's going concern.

A great deal of controversy arose with the introduction of the 4th Directive resulting in Germany being one of the last countries to implement the Directive. This delay could be linked to the close relationship between accounting law and tax law and a reluctance to introduce legislation, which would impinge on tax law. This, according to Gebhardt (1993), is apparent, as financial accounting is closely regulated by law and legal interpretations and is relied on by the tax authorities.

All companies prepare financial statements using GAAP (HGB §243(1)) and must in addition also present 'true and fair' accounts (HGB §264 (2)), as required by the 4th Directive. This requirement was incorporated into German law (HGB §267(2)) and does conflict in many ways with the German tradition. There is no 'true and fair' override provision and in this regard German law fails to implement the 4th Directive. The concept, '*...den tatsächlichen Verhältnissen entsprechendes Bild...*' (the true and fair view), is a new concept to German law and the literal meaning, according to Langer (1989, p.3), is 'a representation reflecting the actual situation of assets and liabilities (structure, classification), financial situation and the profitability of a company.'

In Ordelheide's view (1997, p.108) 'the functional interpretation of law and the application of the true and fair view seem very similar. Both are relatively imprecise and thus allow accepted interpretations of their meaning to become

⁹⁷ HGB § 273(1).

established, permitting the development and application of compromise solutions which reflect the interests of different parties.'

7.3.1.2. CHARTS OF ACCOUNTS.

Charts have a long history in Germany having been introduced at the beginning of the 20th Century although Gerbhardt (1983) cites evidence of them being first published at the end of the 19th Century.⁹⁸

After World War 1 several industrial groups set up uniform costing systems while uniformity in financial accounting for tax purposes was also encouraged. This process advanced with the development of a national chart of accounts.

Eugen Schmalenbach (1873-1955) was the undisputed leader among German accounting academics. He emerged in the 1920s as a leading business economist and consultant and influenced the evolution of business economics and business administration. His best known contributions to accounting theory are inflation accounting, valuation and the development in Germany of accounting principles. In the 1920s, influenced by the works of Prof. Karl Bücher, he developed a uniform chart of accounts (*Der Kontenrahmen*, 1927) integrating financial accounting and cost accounting. In 1937 the Third Reich adopted a mandatory chart of accounts as an aid to central control. Every system had to meet a fourfold purpose which included accounting and financial statements, business statistics, cost accounting and planning (Coenenberg and Schoenfeld, 1990, p.101).

⁹⁸ J.F. Schär developed systems of accounts for trading companies, breweries, industrial undertakings, etc. as an aid in the preparation of balance sheets and income statements.

About 200 process oriented charts and rules, integrating financial and cost accounting, were introduced for the different industries and trades (Lafferty, 1975, p.51). Uniformity⁹⁹ was then enforced from above and extended to occupied countries including France. With the fall of the Third Reich the concept of charts was abandoned although many sectorial charts were still used on a voluntary basis. By 1949 a uniform chart of accounts (*Gemeinschaftskontenrahmen*) was developed and used by different companies. This continued to grow and by the mid 1950s over 100 uniform charts were used on a voluntary basis (Most 1961, p.166). A uniform chart (GKR) was recommended for industry which, according to Gerbhardt (1993, p.7) was neither fully accepted nor fully used. This is evidenced by the fact that even the AktG did not enforce a particular chart of accounts.

Charts however remained mandatory in East Germany and in 1955 a new chart for companies in the centrally planned state economy of the GDR was introduced.

In 1971 a new chart called *Industrie Kontenrahmen* (IKR)¹⁰⁰ was published by the Federation of German Industry (BDI) but its adoption was not made compulsory. The IKR was developed to meet the needs of the AktG but was still not accepted. In 1986 it was amended to meet the 4th Directive requirements but did not have a unified system. Gerbhardt (1993, p 5) analyses the IKR and is of the opinion that as it maintained a separate finance and cost accounting division, it did not replace the GKR, nor the industry specific charts. Consequently both the IKR and GKR were used and at present neither is compulsory. (Alnajjar and Volz (1991) cite BASF as an example of a group that still makes use of old charts).

⁹⁹ By 1939 German accounting had a high degree of standardisation although there was no uniformity because of the considerable differences between the 'sector specific' charts.

¹⁰⁰ The chart of accounts (*kontenrahmen*), unlike that in France, does not include rules for the recognition and valuation of assets and liabilities as these are contained in the accounting law. They are instead outline charts developed for companies in a particular sector of industry or commerce. Some industrial associations have their own specific type of charts reflecting development especially in cost and computerised accounting. A plan of accounts (*kontenplan*) is an individual chart of accounts designed to meet the special requirements of a specific company and are usually based on a less detailed chart of accounts of a particular industry or commercial sector.

7.3.1.3. THE COMMERCIAL CODE.

The rules of the HGB and/or GAAP apply to all enterprises in the form of AGs, KGaAs, GmbHs, (as opposed to sole proprietorships, partnerships, other than a KGaA, and co-operatives). Large partnerships and single proprietorships fall under the *Publizitätsgesetz* (Law on Disclosure Requirements for large Enterprises - PubLG) and must comply with the HGB. The HGB is supplemented by additional rules contained in the AktG and the GmbHG, which relate specifically to companies with these particular legal structures.

The HGB (§266) sets out a standard reporting format for companies and partnerships defined as large enterprises, detailing the classification and order to be used. This format must be consistent from year to year and any changes must be described and justified in the notes to the accounts. A horizontal balance sheet format is used showing assets on the left and liabilities on the right (see appendix 2).

Although standardised, further breakdown and additional lines are permitted in the balance sheet and profit and loss account and certain lines may be combined and zero items omitted. No offsetting of assets against a liability or income against expenses is allowed. In valuing a set of items the principle of individual valuation is adopted and the decrease in value of one item may not be offset against the increase in value of another. Valuation methods must be consistently applied with strict adherence to historical cost. The 'going concern concept' is assumed unless facts or operation of law disproves it.

All anticipated risks and losses are brought into account even if they are only incurred after the balance sheet date but prior to preparing the accounts. While all items of income and expenditure are brought into account under the accrual concept, only realised profits are recorded. Notwithstanding this, unrealised losses are taken into account.

While the concept of matching expenditure to income is fundamental, the concept of prudence has priority. This means that all liabilities and losses must be recorded

and uncertain liabilities must be accrued for together with possible losses from uncompleted transactions.

Fixed assets are shown at cost less accumulated depreciation or at a lower value if considered appropriate in the circumstances.¹⁰¹ Extraordinary depreciation to reflect temporary decreases in value can only be provided for in the case of financial investments. Any such depreciation must be reversed if, in the following years the reason is no longer valid, unless the lower valuation can be retained for tax purposes and it is a prerequisite of such retention that the lower value be also retained for financial reporting purposes. In this instance the amount not written back must be disclosed in notes.

7.3.2. FORMS OF OWNERSHIP.

Although businesses can be owned by sole proprietors¹⁰² co-operatives and various other forms, this section only considers commercial partnerships and companies.

Commercial partnerships (*Personenhandelsgesellschaft*) can be summarised under the following headings:

- General partnerships (*Offene Handelsgesellschaft* - OHG) where individual partners assume unlimited liability for the debts of the partnership.
- Limited partnerships (*Kommanditgesellschaft* - KG) where the limited partners (*Kommanditisten*) are liable only to the extent of their contributions while the general partners (*Komplementäre*) have unlimited liability.
- Limited partnerships with a company (usually a GmbH) as a general partner (*Kapitalgesellschaft & Co. KG* - GmbH & Co KG) are very popular as they combine limited liability with the advantage of being taxed as a partnership instead of a company. The shareholders of a GmbH are often also the limited partners in the KG.

¹⁰¹ The options of art 33 of 7th Directive are not used. The use of inflation accounting methods is not allowed. Although details can be set out in the notes to the accounts, this is rarely done.

- Silent partnerships (*Stille Gesellschaft* - SG) exist where an unregistered person (silent partner) contributes capital for a share of profits but is not liable for the debts of the partnership.

While the commercial partnerships are not legal entities separate from their partners, the HGB attributes to them some features also found in legal entities. The partnership may, under its own name, acquire rights and incur liabilities and may sue or be sued.

Companies (*Kapitalgesellschaften*) can be divided into the following groups:

- The private limited liability company (*Gesellschaft mit beschränkter Haftung* - GmbH) is the most popular form of limited liability company.¹⁰³ It is widely used as a vehicle for German subsidiaries of foreign companies and where there is no need to raise capital on the stock market. Unlike the AG the shares are not in bearer form and are registered in the name of the owner. This form of company also has less restrictive legal regulations than the AG.
- The Stock Corporation (*Aktiengesellschaft* -AG) is used especially in international business, where the shares (*Aktien*) are traded on the capital markets allowing the AG to raise funds. Not all AGs however are listed on a Stock Exchange. This form of company can be compared to the PLC in the UK and the SA in France.

Companies, all have independent legal existence and their owners are liable only to the extent of their capital contributions. They are subject to the HGB while, in addition, the AG is also regulated by the AktG.

The determination of company size classification is of importance and is dependent on certain basic criteria (as set out in the HGB). To fall within a specified size

¹⁰² Over 77% of businesses are owned by sole proprietors.

¹⁰³ There are no recent statistics and the latest record shows that in 1992 there were over 500,000 such companies. This form of company was popular with medium-sized and small businesses. See Nobes and Parker, (2000, p.234).

category a company must meet two of the three stipulated criteria detailed in Table 7.10 in two consecutive years.

Table 7.10 The size determination of a company.

Size of company	Balance Sheet total in DM	Total sales in DM	Number of employees
Small	≤ 5.31m	≤ 10.62m	≤ 50
Medium	> 5.31m ≤ 21.24m	> 10.62m ≤ 42.48m	> 50 ≤ 250
Large	> 21.24m	> 42.48m	> 250

Once a company has been categorised as small, medium or large, there are specific disclosure requirements, which then apply. These can be summarised as in Table 7.11 below:

Table 7.11 Disclosure requirements for companies

Financial Statement	Large	Medium	Small
Balance sheet	Unabbreviated presentation		Abbreviated
Profit and Loss	Unabbreviated presentation		Abbreviated
Notes	Full disclosure	Limited disclosure	
Audit	Compulsory		Not compulsory
Management report	Publish	File	Not applicable

Although it is required that small and medium-sized companies make their financial statements available, this, in practice, does not take place and the HGB does not impose any serious penalties. Seckler (1995, p.232) estimates that the number of firms that publish financial statements is 'far below 20%'. In writing about small and medium-sized companies he comments that they 'in particular still prefer to make their financial statements available only to selected outside

addressees (e.g. banks) in order not to disclose any information that might be of interest to competitors.'

7.3.3. HISTORY OF FINANCIAL REPORTING IN GERMANY.

The earliest objective of financial statements was to meet the needs of an individual to keep track of his property. At that time valuation was of little importance and most records dealt in quantities only. As more transactions took place the recording resulted in errors being made and as a result double entry was developed as an aid to control this recording process. To do this it was necessary to attach money values to the transactions but the choice of the valuation method was immaterial and any method that was applied consistently was acceptable.

It was only at a later date that an interest developed in the success of a business. The rules for determining profits were not formed by the bookkeeping practices of the merchants but were generally the ideas of legal reformers who attempted to halt behaviour ranging from dishonourable to fraudulent through the use of law by developing GoB. Past legislation was often undermined by managerial creativity in evading regulations. From the 15th Century articles of incorporation were limited to a 2-5 year period to avoid the Roman law rules that profits of a trading company could only be paid out when that company was wound up.

Great importance was focused on stewardship where managers had to account for the uses made of the funds at their disposal. The limited liability company was created to reduce risks and also to promote business development within the confines of established practice. As a result cost accounting and budgetary control were grafted on later, influencing and being influenced by existing procedures of the time. Other influences on accounting practice were those for assessing tax, the preparation of government statistics and in some instances even price control. This resulted in a single system of accounting, which has adapted slowly to meet the ever-changing needs of the social and legal environment.

In 1794 the German commercial law was first codified and as such it regulated the preparation of accounts and valuation methods. As Germany became more industrialised, so too did its accounting law.

German accounting practice has been influenced by many factors of which the most important is the Commercial Codes of 1861, 1884 and 1897. Asset valuation was tantamount as the protection of creditors and the prevention of any distribution of unrealised profits was of the utmost importance. The 1861 code had little impact on accounting practice and use was made of historical cost. It contained no auditing provisions and delegated responsibility to the directors of companies. In 1884 this requirement was altered and fixed assets were to be shown at original cost less accumulated depreciation while current assets were to be stated at the lower of cost or market value. Every company was required to have a supervisory board and one task of that board was the audit of accounts, although it was entitled to appoint outside auditors.

The 1891 tax reform required companies to prepare annual accounts and as taxable income was determined by the increase in net wealth between two dates, it forced companies to further address the problem of valuation. Companies could apply accelerated depreciation as long as its use was disclosed in the accounts. Companies prepared only one set of accounts, which complied both with tax regulation and with the HGB. As a result the 1897 code required assets to be valued according to GoB. While this did not enforce a valuation based on historical cost, it did attempt to regulate methods used to prevent overvaluations.

In the 1900s German businessmen believed that the main function of annual accounts was to show the value of a company's capital and that this could be obtained from the Balance Sheet. It was only later that they agreed that disclosure should also be made of the results of a company's operations (Kedslie and Hussaen, 1989).

In 1937 the AktG codified general accounting standards and principles for the first time. It re-introduced historical cost valuations and indicated the differences

between valuations of various types of fixed assets and current assets. This was brought about by the large numbers of corporate failures in the 1920s and early 1930s and the need to protect creditors. With this policy of creditor protection, the dominant principle was of prudence, which has remained ever since.

In 1965 additional principles were incorporated into the revised AktG, mainly to cater in greater detail for the needs of shareholders. This was based on the assumption that it was impossible for management to present annual financial statements to shareholders because shares were held in the form of bearer certificates and shareholders were therefore unable to exercise their right of supervision.

Until 1985 the AktG remained virtually the sole source of accounting law in Germany and represented what was considered to be generally accepted accounting principles. It set out the format and content of the balance sheet and profit and loss account, although it did not apply to unincorporated enterprises nor limited partnerships and therefore those forms of enterprise were flexible with their accounting.

The above historical outline is clearly an indication that even with efforts being made by the EU, the IASC and other international and national bodies, the needs of a country will always prevail. Every country wants to have its own mark on the practices adopted by it in the preparation of its financial statements. These statements must incorporate accounting practice which is not only useful for the specified purpose but must use standards which represent 'good' practice even if they are not the 'best' practice.

In December 1999 at a meeting in Berlin organised by Deloitte Touche Tohmatsu (DTT), the accounting profession was asked to take an active role in forging a uniform set of international standards. Rick Murray the managing director of DTT legal and regulatory affairs stated that 'Germany has a long history of having the most non-standard accounting conventions of the world's leading economies.'

Germany was considered a relationship market - 'where you know what you know because of who you know.' (www.electronicaccountant.com).

7.3.4. REGULATORY BODIES.

The German legal system as developed in the 19th century designed to cover all eventualities, is based on written law (Gallhofer,1989, p.17). Accounting regulations form part of this prescriptive system, which is a characteristic of German accounting. The law influenced by tax regulation is designed to always be there to protect the creditor. This gives German accounting its reputation for conservatism involving understated assets and secret reserves.

HGB §273 (1) requires that financial statements must be prepared in accordance with required accounting principles. These principles (GoB) embody certain general accounting principles without being incorporated in codified law. They are summarised in Table 7.12 below.

Table 7.12 Generally accepted accounting principles

Fundamental conventions	Basic concepts
Entity concept (for a definite period of time)	Completeness (account for all transactions)
Continuity (going concern unless disproved by facts or operation of law)	Truthfulness and clarity
Historical costs	Prudence

7.3.5. PROFESSIONAL BODIES.

Although the first creation of statutory audits took place in 1931 it was only in 1961 that a national system of regulation was reintroduced with the introduction of the *Wirtschaftsprüferordnung* (Auditors' Act -WPO). The WPO led to the establishment of the *Wirtschaftsprüferkammer* (Chamber of Auditors - WPK) as the regulatory body for the profession under the supervision of the Minister of

Economics. The WPK is responsible for educating accountants, which it delegates to the *Institut der Wirtschaftsprüfer* (German Institute of Certified Public Accountants - IdW) and the observance of professional standards. Members of the WPK are certified auditors (*Wirtschaftsprüfer* - WP) and certified accountants (*Vereidigte Buchprüfer* - vBP).¹⁰⁴ WPs are by law required to be members of the WPK.

The growing demand of shareholders, creditors and other lenders for audited accounts has led to the profession's growth. Although it is a relatively young profession as compared to the UK, it is establishing an influence in spite of the dictates of tax law.

The IdW was established in 1931 at the time that the government introduced a statutory audit for publicly-quoted limited companies. It is a small body of about 9500 members and deals with the education, training and the issuing of recommendations and opinions. It does not try to define accounting principles, as is the case for example in the UK. If anything, its focus is on the interpretation of the regulations set in German legislation. It publishes statements on principal accounting and auditing questions, which then serve as generally accepted standards and principles. These pronouncements have no legal standing and although the profession often adopts them, do not have to be followed (Al Hashim and Arpan, 1988, p.31).

7.3.6. THE TAX SYSTEM.

Accounting for taxation developed from the mid-19th Century with the first tax balance sheets being prepared by the railway companies. A tax official, Von Wilmowski was the first author to demand that historical cost be used as a valuation ceiling for all assets and stocks and that all anticipated losses be recognised.

¹⁰⁴ The difference is that the latter have simplified admission and examination procedures and can only perform statutory audits of medium-sized limited liability companies or GmbHs. WP must undertake all other statutory audits.

Tax rules contained in the income tax law (EStG) and the income tax directives (EstR) continue to exert an influence on accounting practices. This creates difficulty on accounting practice as accountants are forced to comply with these rules which change frequently.

With this close relationship between accounting and taxation the former remains heavily influenced by profit minimisation considerations. It was argued by Blake, Amat and Fortes (1996, p.246) that 'in one significant respect, pension costs, the dominance of tax law in Germany has made accounting practice less conservative than in the UK.' The tax accounts are derived from the commercial accounts and are not an independent set of accounts. A company can only claim tax incentives if the same treatment is applied in the commercial accounts. This means that the taxable profit of a company must be derived from the earnings reported in the published accounts and any particular accounting treatments claimed for tax purposes must be shown. (the 'conformity rule').

There are many detailed valuation rules and some bookkeeping procedures prescribed by tax laws and regulations, for example valuation methods and depreciation rates. It is observed by Langer (1989) that nearly all tax allowed special depreciation also affects published accounts.

The tax authorities, according to Benny (1975), are more concerned with the balance sheet than with the profit and loss account. The reason for this is that in determining profit, they consider that it is the difference between the assets at the end of the one year and the beginning of the next. This means that the valuation of assets is of the greatest interest and is considered to be of utmost importance. Corporation tax uses a balance sheet called the *Steuerbilanz* which is prepared in accordance with tax regulations and which could be said to be the legal accounting requirements. The published balance sheet, the *Handelsbilanz*, is used as a basis for preparing this account and therefore the latter cannot show higher valuations than in the tax account.

All this illustrates that the tax system is an integral part of the legal system and it is a fundamental legal principle that the value of profits, assets and liabilities in the accounts may be no higher nor lower than their counterparts as allowed for tax purposes.

There is a considerable overlap between the tax regulations and the determination of accounting methods, which means that problems such as deferred tax do not exist. There is no requirement to reconcile the tax and accounting rules, since, to a large extent, they are the same. This concept is known as the *Maasgeblichkeitsprinzip* ('congruence') principle and is incorporated into EStG §5. While the *maasgeblichkeitsprinzip* means that the accounts, drawn up in accordance with GoB, form the authoritative basis for the tax computation, the *umgekehrte maasgeblichkeitsprinzip* ('reverse congruence') allows the tax computation to have a retroactive effect on the financial statements. It makes taxpayers take into account tax consequences or allow for a conservative calculation of profit.

The emphasis on the compliance with tax rules and regulations in single enterprises limits the usefulness of German financial statements for decision making by users. Reported profit and valuations in the accounts will reflect the most favourable tax position and may not reflect the economic profitability or the true position of the company.

Both the *maasgeblichkeitsprinzip* and the *umgekehrte maasgeblichkeitsprinzip* as contained in EStG §5(1) only applies to individual accounts and does not have an effect on the group accounts. Although German law requires that consolidated accounts be prepared in terms of the HGB there is no commitment to the specific values of the individual accounts. Therefore there is no need for the consolidated accounts to be tax driven. This factor can be used to advantage and can help increase equity.

7.3.7. CONSOLIDATED ACCOUNTS.

Consolidation was first made compulsory under AktG (1965). At that time there was no rule requiring foreign subsidiaries to be consolidated but some AGs did 'world accounts'. What was required was that all domestic holdings in excess of 50% had to be consolidated and group relationships were identified where a company was under unified management or control. With the adoption of the 7th Directive into German law, the previous practices of excluding foreign subsidiaries from consolidation, is now superseded and German methods of consolidation have moved towards the UK practice.¹⁰⁵

From 1990 onwards consolidated accounts became more important and steady progress was made towards standardised group accounting practices. Effective for the financial years commencing after 31 December 1989 and applicable to all groups headed by an AG, KGaA or GmbH, it stipulated that accounts must be consolidated if there is de facto control (<20%) or if an entity exercises control. Control is determined by examining if the parent owns a majority of the voting power; controls the board of directors or has a dominating influence through a contract with the investee company.

In the transitional provisions there were options allowing companies to exclude foreign subsidiaries; not to apply identical accounting and valuation principles; and a simplification in capital consolidation. Deviations were allowed for non-company enterprises where group accounts were only required if control is exercised and not if they only have the 'ability to exercise'.

Provisions dealing with consolidation are set out in the HGB §290-315. Under the HGB the parent company is required to prepare consolidated accounts if it and its subsidiaries meet two out of three of the criteria in Table 7.13 below.

¹⁰⁵ Consolidation techniques are the same as in the UK and US except that there is the alternative of setting off the parent company's investment account against its share in the subsidiary's equity measured either as at the respective balance sheet date or date of acquisition or initial consolidation of the subsidiary.

Table 7.13 Criteria for the preparation of consolidated accounts.

	Balance Sheet total	Total sales	Average number of employees
Before consolidated adjustments (gross)	>63.72m	>127.44m	>500
After consolidated adjustments (net)	>53.1m	>106.2m	>500

In addition a consolidation is required regardless of its size, if the securities of the parent company or any of its subsidiaries are traded on a stock exchange within the European Union.

There are three forms of consolidation:

- Full consolidation of subsidiaries using the purchase or acquisition method;
- Equity accounting of associates where there is a significant influence on the policies of an enterprise of between 20% and 50% of the voting power (HGB §311). The full equity value of the investment is shown in the balance sheet with a separate disclosure of goodwill in the notes or there is a split up in the balance sheet; and
- Proportional consolidation for joint ventures as required by HGB §310(2).

Subsidiaries may be excluded if they are not significant in relation to the group's net worth, financial position and results or if the exercise of the parent company's rights is impaired or information required for the consolidation involves an undue expense or delay or if the investment in the subsidiary is held solely for resale.

Subsidiaries must be excluded if the activities are so divergent from other group enterprises that its inclusion would be detrimental to a true and fair presentation (§295). There is also an exemption for subsidiaries resident in a member state of the EU where a foreign company prepares its consolidated accounts in terms of EC

Directives, provided the minority shareholders of the German parent do not oppose the exemption.

The consolidated financial statements must include a consolidated balance sheet and profit and loss account together with notes to the accounts disclosing many aspects of the group. These include accounting and valuation methods, inconsistencies, justifications and quantification of their effects on net worth, financial position and results; the basis of translation; the name and legal seat of, and size of the investment in all subsidiaries included in the consolidated accounts and/or companies accounted for by the equity method; reasons for excluding companies from consolidation or equity accounting. All listed companies must also include a segment report as well as a cash flow statement (see 7.3.10).

7.3.8. FINANCE.

Throughout the late 1980s the German equity market was a poor performer compared to other European markets. As the tax system made it unattractive for a German investor to hold shares, the focus of investment was on fixed income investments. This resulted in many smaller and medium sized companies remaining privately owned and controlled.

Early in 1990 trading soared with a lot of speculative buying. This was short lived and possibly exacerbated by a failure of the DDR companies to list their shares. At present there are only 662 domestic quoted companies (see Table 2.4), many of which are closely controlled, resulting in a narrow equity market. Equity issues are in the view of Ordelheide (p.37) not an important source of finance and private shareholding is not widespread with only about 17% of shares in the hands of individuals. This is compensated for by the provision of self-finance and, most importantly, loan capital, mainly in the form of bank facilities.

Banking, automobiles and chemicals account for a high percentage of market capitalisation and with the growing need for international finance there is the trend by German companies to look at markets outside Germany. The listing by Daimler Benz in 1993 on the New York Stock Exchange marked the first step by a German

company into that market and this was followed by a number of other German companies such as Deutsche Telecom, Veba and Hoechst. According to the NYSE web site (www.nyse.com/listed/Euro- 2 May 2000), there are 12 German groups currently listed on the NYSE.

The all-purpose nature of the commercial banks is a significant feature of the German financial system, providing full finance and financial services. In particular they act as issuing houses and underwriters and handle stock exchange dealings. They participate in companies, hold proxies on behalf of individual shareholders and sit as supervisors on boards (Lafferty, 1975, p.72). This gives them the opportunity of obtaining detailed, current information and therefore there is little pressure to increase the usefulness of the accounts. Their overall power may be overstated but nevertheless they still have large direct and indirect participation. There can often be a conflict with the banker as creditor, director and shareholder and also as proxy holder.

A number of medium sized companies have now gone public because the old shareholders were not willing to give additional funds and there is also a reduction in the disadvantages of, for example, publication of results. This is in spite of the fact that from a tax point of view, loan capital financing because of the interest charge, is preferable. In addition there is a high funding via pension accruals, because, from a tax, administration and financial point of view, this form of funding is often preferable to external funding.

With the current situation of a small number of listed companies and low equity ratios, coupled with the use of bank finance and pension accruals finance, it is not surprising that the stock exchange has little influence on accounting rules. The increasing pressure, however, to facilitate the raising of capital has resulted in the changes of 1998 which are discussed in 7.3.10.

7.3.9. NEW DEVELOPMENTS.

As a result of pressure by many large companies looking towards globalisation and the need for international harmonisation, two new laws were introduced in April and May 1998.

These laws were described as:

- The Law for Control and Transparency in Companies (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich -KonTraG*) ; and
- The Law for improved Equity raising Capabilities (*Kapitalaufnahmeerleichterungsgesetz -KapAEG*).

They were passed by the legislature and helped introduce a number of changes into German accounting.

1. Listed companies can use international accounting standards and no longer have to abide by HGB rules. From 31 December 1998 they are required to prepare cash flow statements and segment reports as part of their notes to the accounts. As there are no German standards for these¹⁰⁶ the companies are using SFAS 131 and IAS 14 for Segment Reporting and SFAS 95 and IAS 7 for Cash Flow presentation. In addition they must either prepare consolidated accounts according to German GAAP or any other internationally recognised GAAP such as US GAAP or IASC standards.
2. The German Accounting Standards Committee (*Deutsches Rechnungslegungs Standards Committee – DRSC*) was formed on 3 September 1998¹⁰⁷ and, in terms of HGB §342, the Ministry of Justice was able to delegate its power to the new committee. The aim of the committee is to develop accounting standards for consolidated accounts. These it will put forward as

¹⁰⁶ There was a legal requirement for a split of turnover into geographic areas and product lines in HGB §317.

¹⁰⁷ It is noteworthy that the idea of a standards committee is so unique in Germany that there is not even a German translation for the concept. This results in the use of the English words 'standards committee' within the German translation.

recommendations to the government for consideration. The DRSC will also act in a consultative role in developing new legislation and will in addition represent Germany at various international forums.

3. There is to be an extension of the strict accounting, auditing and disclosure requirements to GmbH & Co as their exclusion was never accepted by the EC and therefore this is only a correction of the situation.

7.3.10. CONCLUSION.

In order to understand the divergence in accounting between the Anglo-Saxon group and the Continental group certain basic facts should be highlighted.

There are many individual differences between German and Anglo-Saxon reporting. This is mainly due to the fact that reporting in Germany is based on a different foundation.

- Profit is the amount that can be distributed without any danger to the capital base. It is considered that meeting the needs of the user is less important than in the UK.
- Financial statements are tax accounts.
- Economic policy places a great emphasis on monetary stability. Revaluation or inflation accounting techniques would be considered a public admission of inflation and therefore are not allowed or even considered.
- Earnings and tax earnings are measured prudently.
- Large companies such as Daimler and Schering are less conservative in their consolidated accounts. The reason for this is that the consolidation does not affect the profit distribution as dividends and tax is based on the individual company account.
- Under the law the obligation to prepare accounts and especially their publication is an invasion of privacy and this requires the approval of the

legislature. Neither the stock exchange nor the IdW has the power to set standards. Even with the formation of the DRSC, it too can only recommend accounting standards. Legal rules are explicit and any additional refinement and interpretation is made by the courts (especially tax courts) and the 'legal interpretations market', where professionals and academics offer their services together with the opinions published by the IdW.

- Reporting is far stricter for companies than for other business forms although it must be pointed out that very large unincorporated companies are treated like companies.

Accounting opinion in Germany is that compliance with legal requirements ensures a true and fair presentation even if the law allows exceptions from GAAP. In the creation of hidden reserves (*Stille Rücklagen*), the legal opinion is that commercial financial statements can no longer form the authoritative basis for tax accounts if the true and fair principle is adhered to. This is in spite of the fact that in German law (HGB §264 (2)) all financial statements present a true and fair view but do so through additional disclosures in the notes to the accounts.¹⁰⁸

Because small and medium enterprises prefer not to make their financial statements available as, in their view, they may be used by competitors, a very small percentage of small and medium companies publish financial statements. This is further exacerbated by the fact that there are no serious penalties for non-publication.

As set out earlier the rules are different for AGs and GmbHs with a variety of implementation dates. In all cases companies were allowed to bring the rules into effect at an earlier date.

¹⁰⁸

This is based on the theory that separation should be made of the true and fair view in the notes from true and fair in the accounts.

7.4. THE UNITED KINGDOM.

The UK is an industrial economy highly dependent on the activities of business organisations, be they companies, partnerships or sole owners. The capital market is well developed and ranks third in the world in terms of volume of transactions (after Tokyo and New York). Because of its market sophistication, there is encouragement for active investor participation in providing finance and this results in financial reporting focusing on the needs of investors rather than the need of the government.¹⁰⁹

While the law (especially the Companies Act) provides the broad framework for financial reporting, the professional bodies, stock exchange and other related independent bodies add detailed methods to make the law operational.

7.4.1. LEGAL SYSTEM.

The UK operates a 'common law' legal system that is not found in either Germany or France. This legal system has statutes which set out in general terms the law of the land. These are subsequently interpreted by the courts creating case law that is used as a supplement to the statutes. Common law can be said to be an attempt to answer a specific case without setting down a general rule for the future.

The system is evident in the rules relating to companies where they are incorporated under the Companies Act of 1985 (as amended in 1989). The Companies Act¹¹⁰ contains the rules relating to the limited liability companies with the major accounting provisions contained in Part VII of the Companies Act (§221-§262). The prime requirement of §226(2) is that the accounts of the company and the group (§227) should give a true and fair view¹¹¹ of the financial affairs and performance of a company and group and this requirement overrides all other provisions of the Companies Act and pronouncements of the professional bodies.

¹⁰⁹ It can be said that accounting in the UK is oriented towards the needs of large, listed companies and that it is dominated by the profession.

¹¹⁰ All references to the Companies Act mean the 1985 Companies Act as amended by the 1989 Companies Act.

¹¹¹ There is no definition of true and fair view in Statute law nor is there any decided case law.

Although there is no definition in the Companies Act, accounts must be prepared on the basis of going concern, accruals, consistency and prudence. Accounting policies must be consistently applied and there must be full disclosure.

Companies are required to present to shareholders an audited financial statement in a pre-determined format together with a directors' report. Copies of these documents must also be filed with the Registrar of Companies.

The varying requirements are indicated in Table 7.14 below. These requirements are dependent on the size of a company as shown in Table 7.15.

Table 7.14 Summary of filing requirements for UK companies

Requirements	Small Company	Medium Sized Company	Large Company
Balance sheet	Abbreviated	Full balance sheet	Audited accounts
Profit and loss account	Not required	Abbreviated	Audited accounts

It should be noted that in the case of large companies they may, in certain circumstances, send shareholders summary financial statements.¹¹²

Company law prescribes only the basic accounting requirements with the detail contained in the accounting standards or in stock exchange regulation. The amount of detail in the statutes including the form and content of the accounts and the notes, was increased by the 1981 Act while the 1989 Companies Act amendments were introduced in order to implement the 7th and 8th Directives.

7.4.2. FORMS OF OWNERSHIP.

In the UK there are various forms of company ownership. These can be broadly described as:

¹¹² Until 1995 all companies were subject to audit. At present private companies with a turnover under £350000 are exempt. This is due to be increased to £1m.

- The public limited company (PLC) which may make an issue of shares to the public (only public companies can be listed) ;
- The private limited company (Ltd) which is not allowed to offer their shares to the public;
- Companies limited by guarantee; and
- Unlimited companies.

The divisions of PLC and Ltd were created in 1980 after the 2nd Directive was introduced into UK company law. The division is very artificial, as, unlike Germany, there is no culture in the UK for small and medium sized companies.

Nevertheless the distinction for financial reporting exists between the different sizes of companies as set out in Table 7.15 below. Companies not falling into one of the categories shown below are deemed to be large companies and include all listed companies.

Table 7.15 Size limits for companies in the UK

Company size	Turnover	Balance sheet total	Employees
Small	£2.8m	£1.4m	50
Medium	£11.2m	£5.6m	250

7.4.3. HISTORY OF FINANCIAL REPORTING IN THE UK.

The United Kingdom was one of the first countries to institute modern financial reporting. Company law and the accounting profession have their origins in the mid 19th Century with the formation of limited liability companies.¹¹³ Although there were no mandatory regulations on accounting and auditing in the company law this changed at the start of the 20th century and the introduction of rules became

¹¹³ Joint Stock Companies Act of 1877.

increasingly apparent. The general requirement was to prepare and file financial statements with the Registrar of Companies and to make audited balance sheets available to shareholders. Initially no profit and loss account was required nor were details given as to what need be contained in the balance sheet.

The 1948 Companies Act was the principal act (with amendments) until 1985 when all amending acts were consolidated into the Companies Act 1985 consisting of 747 sections and 25 schedules. The accounting and auditing provisions were subsequently amended and restated by the 1989 act. This amending act implemented the 7th and 8th Directives (the 4th Directive was already implemented by the 1981 amendment) and brought into UK law detailed accounting rules and reduced the flexibility of earlier regulation.

Although regulations on companies are contained in the Companies Act, there are a number of questions affecting accounting where the law is not clear. When accounting standards gave broad principles only, this allowed for the use of judgement in applying standards. Lately there has been criticism that the standards being imposed are so lengthy and detailed and that so many are being introduced that it is likely that discretion cannot be used and that a 'cook book' approach will now be introduced. It is argued that it is not the role of accounting standards to place financial reporting in a straight jacket. Judgement is important in the application, and departures from standards should be disclosed and explained in the accounts with details of their effects.

Accounts are designed to report to shareholders on the management and control of the business and to give shareholders and investors information on the company and the group. In preparing or auditing accounts reference must be made to the Companies Act; the various statutory instruments; the SSAPs and FRSs and, in the case of listed companies, the Stock Exchange Yellow Book (Admission of Securities to Listing) which covers additional requirements such as corporate governance.

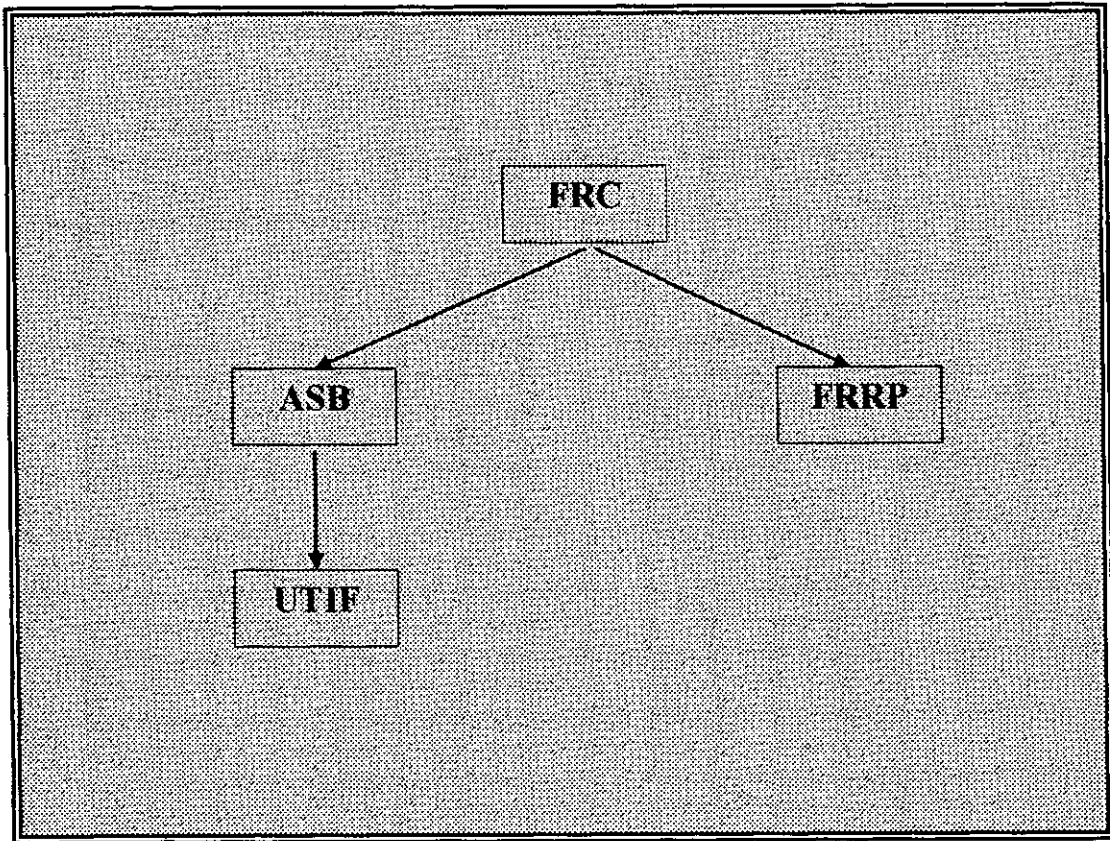
Accounting standards constitute strong authority although there is no case law to test this assumption. They are recognised in § 256 of the Companies Act where it is provided that accounts of a public or other large company must state whether they have been prepared in accordance with 'applicable accounting standards'. Where this is not the case then they need give particulars and reasons for any material departure.

It is important to note that where the company is listed, the rules of the UK Stock Exchange and the SEC differ. In the US, the SEC is able to lay down detailed rules for listed companies but this is not the case in the UK. The development of accounting policies and practices in the two countries evolved in different ways. In the US the SEC has published standards since the 1930s. There are various standard setting bodies. There are strict criteria, detailed explanations and interpretations. Principles are often the same in the UK and the US but the application is different. US GAAP has a clearly defined meaning while in the UK reference to GAAP is not a generally used term.

7.4.4. REGULATORY BODIES.

The Financial Reporting Council (FRC) established in 1990 to replace the Accounting Standards Committee (ASC) operates and supports the work of the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP). These bodies are charged with the overall responsibility for accounting regulation in the UK.

Figure 6 The Structure of the FRC



Whereas previously the ASC had no statutory recognition, the ASB is the standard making body and its standards are ‘accounting standards’ for the purpose of §256(1) of Companies Act. The ASB adopted all the accounting standards issued by the ASC and those standards (SSAPs), together with the new standards issued (FRSs), now have the force of law and reporting entities are required to disclose if they have complied with them in the accounts.

There are three ways to secure their compliance:

- The standards provide authoritative guidance on how a particular transaction or event should be reflected in the accounts. Compliance with these standards would normally be necessary for the accounts to reflect a true and fair view;

- Large companies are required by law to state if their accounts are prepared in terms of the standards and give reasons and details of any departure (Sch 4: §36A);
- The FRRP examines and questions departures from the accounting requirements of the Companies Act.

The Urgent Issues Task Force (UITF), an associated body of the ASB, is responsible for investigating urgent matters not covered by existing standards or where unsatisfactory or conflicting interpretations of standards have developed or could develop. Abstracts of the UITF (see appendix 3) are not mandatory but are part of the corpus of practice for determining a true and fair view. The stated views are normally accepted by the ASB as having similar authority to its own.

The FRRP by agreement with the DTI examines and questions any departures from the Companies Act's accounting requirements (including accounting standards) by public and large private companies.¹¹⁴ It has no direct powers of sanction and so far has achieved its aims by persuasion; its threat being that complaints will be taken by it before civil courts.

The Companies Act made the preparation and audit of accounts of UK companies and groups more complex by the adoption of the EC Directives. Even so legislation is relatively flexible allowing for the options of the Directives and relying on detailed guidance by the accounting profession.

7.4.4.1. ACCOUNTING STANDARDS.

These are now issued within the constraints of the law by the ASB and called Financial Reporting Standards (FRSs). Standards (see appendix 3) contain disclosure and measurement rules and describe methods of accounting approved for an accounting application so as to give a true and fair view. The true and fair override is used where needed and the ASB has also been able to restrict options legally available or remove an option. Examples are as follows:

¹¹⁴ All other companies are dealt with by the DTI itself.

- The Companies Act allows the use of LIFO while SSAP 9 suggests that a company would not show a true and fair view if it used LIFO.
- The Companies Act states that all fixed assets should be depreciated while SSAP 19 states that to reflect a true and fair view, investment properties should not be depreciated.
- FRS 3 abolishes the concept of extraordinary items by its wide definition of ordinary items.

Standards are divided into three groups.

- Disclosure issues such as cash flow statements as required in FRS 1;
- New problems; and
- Measurement rules covering, for example, government grants as detailed in SSAP 4.

In the past there was a great deal of disagreement on accounting practices and in many cases standards were disregarded. Enforcement was a major problem and accounting bodies did not take disciplinary action as neither the government nor the stock exchange felt that it was up to them. The greatest pressure to secure compliance was any threatened court action for negligence. With the advent of standards, professional independence was reduced and so too the risk of charges of negligence.

Without a definition of 'true and fair' companies have at times attempted to push the interpretation of the rules to extremes. The ASC obtained an opinion in 1983 on the meaning of true and fair. It stated that financial statements would not be true and fair unless the information they contained was sufficient in quantity and quality to satisfy the reasonable expectations of readers to whom they were addressed.¹¹⁵ In an opinion by Arden (1993a) she stated that the Courts would find that financial

¹¹⁵ Opinion given by Hoffman and Arden, September 1983. This was followed in March 1984 by a supplementary joint opinion.

statements need comply with accounting standards in order to give a true and fair view.

7.4.5. PROFESSIONAL BODIES.

The highly organised accounting profession, first established in the 1850s, plays an important part in the interpretation and implementation of company and tax legislation and in providing detailed guidance. It can be said that the influence of the profession on standard setting and financial reporting has decreased since the formation of the ASB although it still has a great deal of indirect influence.

The Consultative Committee of Accountancy Bodies (CCAB) is an umbrella organisation that embraces the six major accounting bodies in the UK. In the past the CCAB was there to promote the work of the ASC and to approve the Statements of Standard Accounting Practice (SSAPs) issued.

The ICAEW was one of the first groups in the world to issue accounting pronouncements when in 1942 it issued 2 recommendations. There usually were guidelines of best practice (addressed to its members), but they had a strong influence on preparers and users

Procedures evolved and in 1970 a Statement of Intent was issued and the Accounting Standard Steering Committee (ASSC) was established to work in close co-operation with the various accounting groups and other interested groups, for example, the stock exchange and CBI to promulgate standard accounting practice.

The intention was to create standards that would allow for:

- Narrowing the areas of difference and the variety of accounting practice;
- The disclosure of accounting bases;
- The disclosure of departures from established definitive accounting standards;
- A wider exposure for major proposals on accounting standards;

- A continuing programme for encouraging improved accounting standards in legal and regulatory measures.

In 1976 the Committee changed its name to the Accounting Standards Committee (ASC) and it worked under the CCAB. This committee, consisting of accountants mainly from the auditing firms, was set up to defuse a situation that had arisen in the 1970s where there was a great deal of criticism on misleading accounts. It lacked the authority to issue new standards at will and gave them over to the CCAB who issued SSAPs after being developed by the ASC. This meant that the CCAB required the approval of the six sponsoring bodies, each of whom was responsible for adopting and enforcing the standards on its own members. Although accounting standards have been published since 1970 there are significant areas where there are no statements and in certain cases where standards do exist there are often options available. The ASC could not take a strict line on any matter as was well illustrated with their attempt to introduce inflation accounting.

It was as a result of the crises in confidence that changes were seen to be needed. The Dearing Committee review in 1988 proposed a new approach that was adopted. This resulted in the ASB being formed in 1990 under the supervision of the FRC and independent of the profession (see Figure 6).

During its existence the ASC made no attempt to construct a conceptual framework. This was favoured by the ASB and it issued a 'Statement of Principles for Financial Reporting' (SOP) in 1995. This SOP was closely modelled on the conceptual framework of both FASB and the IASC but showed sympathy with current cost accounting, thereby evoking criticism. As a result it was withdrawn and re-issued in 1999.

7.4.6. THE TAX SYSTEM.

Income tax was introduced into the UK in 1799 to help finance the war with France. The tax system was withdrawn in 1815 and only re-introduced in 1843.

Financial reporting in the UK is clearly investor orientated and this is in a way reinforced by tax law that allows various investment incentives. As is the case in the United States tax law does not serve as the basis for financial reporting, unlike Germany where tax regulations dictate the manner in which transactions are recorded.

UK tax law states that only statute law and court decisions can determine what is income for tax purposes and unlike Germany no use is made of accounting measurement rules. It is the Finance Act that determines for tax purposes what assets are to be depreciated and the rates to be applied. All this is independent of the rates used in the company's published accounts.

Accounts are prepared according to UK GAAP and are then adjusted to arrive at the taxable income. Adjustments would include replacing depreciation with 'capital allowances' and setting off previous tax losses against current income. Other adjustments are for provisions (where they must be specific for tax purposes) and for example, entertainment (which is disallowed) or fees (which may be classed as capital expenditure). All these adjustments are reflected in the tax return and therefore the user of the accounts need not reclassify or adjust the financial statements as presented.

Companies are not forced to try and minimise tax by selecting higher rates of depreciation in their accounts, as not all assets are subject to depreciation under tax rules, e.g. office buildings. All this indicates that accounting profit is not the same as taxable income and as a result providing for deferred taxation is a standard practice.

7.4.7. CONSOLIDATED ACCOUNTS.

§227 of the Companies Act requires that the parent company shall prepare group accounts consisting of a consolidated balance sheet and consolidated profit and loss. In addition FRS 1 requires the presentation of a group cash flow statement.

In the UK group accounts comply with Schedule 4A of Companies Act. As a result of the 1989 Companies Act amendments, the criteria now is control rather than ownership and the definition uses the term 'undertakings', thereby including partnerships and unincorporated joint ventures.

7.4.7.1. HISTORY OF CONSOLIDATION.

Unlike the US, the UK was very slow in publishing consolidated accounts and the history surrounding their preparation in the UK dates back about 50 years.¹¹⁶ Over time there has been changes in both the form and the content. Until the late 1940s parent companies only sent their shareholders individual accounts of the parent company.¹¹⁷ The parent company showed an investment at cost and dividends from subsidiaries was the only disclosure in the profit and loss account. No information was given about the assets and liabilities controlled by the group nor were any details given of the profitability of the subsidiaries.

Nevertheless, the view held in the UK was that consolidation was a supplementary report to the parent company's report and not a substitute. It was only in 1947 that group accounts, in addition to the individual accounts of the parent company, were required in the UK.¹¹⁸ This is still evident in that the Companies Act still requires the parent company's balance sheet although Group accounts are the main accounts of UK companies.

¹¹⁶ The first holding company dating back to 1832 was created in the USA. In the 1890's the first set of consolidated accounts was published and in 1900 US Steel produced accounts, which consolidated their group and fully disclosed the profits of the subsidiaries and not just the dividends received. By 1920 this was generally accepted practice in the USA.

¹¹⁷ By 1977 only 32.5% of the large UK companies produced consolidated balance sheets and 17.5% produced consolidated profit and loss accounts. This is based on a sample of companies in Bircher (1988).

¹¹⁸ The Companies Act 1947 did not include detailed rules on the preparation of group accounts. It only specified when subsidiaries could be excluded. The holding company could also choose between several options in preparing its group accounts. It allowed group accounts to be prepared in several ways, one (normally) being consolidated financial statements. These options were removed by Companies Act 1989, which requires group accounts to be presented in a single set of consolidated financial statements of the company and its subsidiaries. Underlying the present rules on consolidation in the UK is the 'parent company concept' which is one of the three concepts namely: Proprietary concept; entity concept; and parent company concept. Consolidated accounts must comply with the standard format as if the group was a single company.

In 1978, following on the issue of IAS 3, SSAP 14 was issued and specified that consolidation becomes the format for the presentation of group accounts. Its stated method of preparing consolidated financial statements on an item-by-item basis, eliminating intra-group balances and transactions and unrealised intra-group profits and losses, was well understood in the UK. With the incorporation of the 7th Directive, SSAP 14 was no longer consistent with company legislation. There were conflicts between the accounting standards and the new legislation and FRS 2 *Accounting for Subsidiary Undertakings* was issued in July 1992. FRS 2 accounting practices were standard practice in respect of consolidated financial statements for periods after 23 December 1992 and brought accounting standards in line with company legislation and tried to eliminate the off balance sheet finance problem.

Although the 7th Directive was intended to harmonise presentation there is still significant scope for accounting diversity. According to Nobes (1988), the range of options results in many alternative ways of preparing group accounts. The Companies Act lays down disclosure and valuation criteria, and there are specific provisions relating to group accounts. Uniform accounting policies are required under the Act and these must be applied, failing which disclosures have to be made.

7.4.7.2. DEFINITION OF A SUBSIDIARY.

Until 1989 a subsidiary was defined in the Companies Act as a company where the parent was a member of it and controlled the composition of its board of directors or held more than half the nominal value of its equity or the company was a subsidiary of another company. At the time there were a great number of schemes that enabled the parent to control another enterprise without it being classed as a subsidiary and obviously without having to consolidate the other enterprise. The reasons for this included selling goods to such controlled non-subsidiaries and recording a profit, keeping assets and liabilities off the consolidated balance sheet to improve gearing and to avoid breaking debt covenant restrictions. Some off-balance sheet financed non-subsidiaries were accounted for as associates that allowed the use of the equity method.

With the introduction of the 7th Directive into UK legislation via the 1989 Companies Act amendments, the definition of subsidiary for accounting purposes and also the criteria for consolidation, was changed. The amendment introduced the term 'subsidiary undertaking' and as a result brought many quasi subsidiaries into the ambit of the act. All subsidiaries are subsidiary undertakings but not vice versa. The final version of the 7th Directive accommodated the wide divergences in practice in the EU whilst also moving the member states towards some harmonisation. Consolidated accounts became compulsory only for groups headed by limited liability companies but unincorporated subsidiaries had to be included [See Chapter 6 for details of the definitions].

It is possible for the parent to own no shares in the subsidiary undertaking¹¹⁹ (arguing that control is through a trust), but even so FRS 2 requires consolidation of all undertakings, not only companies. This is brought about by the amended main criteria, which is if control is exercised. Even then, if there is no exercise of control but a 'significant influence' it may still give the company a 'participating interest' in terms of §22 of the Companies Act 1989.

SSAP 14 had wide definitions, which allowed the parent to have controlled subsidiaries outside its group accounts. As a result it was possible to exclude high levels of borrowings and losses. The Companies Act 1989 together with FRS 2 and FRS 5 significantly altered the definition of 'parent' and 'subsidiary.' FRS 2 defines a parent/subsidiary relationship and where there is actual control and influence then it must be brought into the consolidated accounts. Under earlier legislation a company was only a parent if it owned more than 50% of the shares in the subsidiary, or if it was a member of the subsidiary and controlled the board.

7.4.7.3. DEFINITION OF ASSOCIATED COMPANIES.

The 7th Directive defined associated companies and joint ventures and although these definitions were adopted by member states they did not do so in identical ways. In the UK there are statutory definitions of subsidiary and associate

undertakings. The term 'associated company' was replaced by 'related company' in the Companies Act and by 'related undertaking' in Companies Act 1989. This is in conflict with, for example, FRS 9, which uses the term 'associates'.

Since 1970, SSAP 1 *Accounting for associated companies* required all companies with long-term investments that gave them a significant influence, to apply the same approach. Associates are brought into account using equity accounting and the investment company incorporates its share of the pre-tax profits, taxation and post-tax profits of the associate in its consolidated profit and loss account. It adjusted the carrying value of the investment in the balance sheet with its proportion of undistributed profits.

In 1997 FRS 2 superseded SSAP 1 and added guidance to existing statute law and to accounting for joint ventures.

Investments today are generally accounted for at cost in individual company accounts. In consolidated accounts, however, they are treated in a different way.

For associated companies (including joint ventures), the Companies Act allows proportional consolidation. FRS 9 deals with the accounting of associates and joint ventures. The requirements covered in FRS 9 are more detailed than those of Sch 4A: §19 - §22 and therefore can be used to give full guidance on the rules to be applied.

Essentially use is made of equity accounting in the consolidation of associated undertakings and in the case of incorporated joint ventures. Where joint arrangements do not qualify as entities in their own right, then proportional consolidation is applied.

¹¹⁹ Under the new rules the definition is extended to include 'undertakings' which are companies and other unincorporated entities.

Table 7.16 Treatment of investments for consolidation purposes

Investment between 51% and 100%	Full line by line consolidation
Investment between 20% and 50% with presumed significant influence	Associate is consolidated using the equity method.
Between 0% and 19% with assumed passive holding	Investment at cost

7.4.7.4. EXEMPTIONS FROM CONSOLIDATION.

The Companies Act (§229) gives reasons why subsidiaries may or must be excluded from consolidation. These exclusions incorporate Art 13 and Art 14 of the 7th Directive [see Chapter 6]. Small and medium sized groups are exempt from the need to present group accounts (§248-§249) and an exemption also applies if the company is a subsidiary of a parent company in the EU. For exemption to apply irrespective of size, the group must not have members that are listed companies, banks, insurance companies or authorised financial service undertakings.

In the determination of the size exemption, small or medium size groups must satisfy two of the following criteria (shown in Table 7.17 below), as it relates to turnover, balance sheet totals and number of employees.

Table 7.17 Categorisation of companies and groups

	Medium size limits £m	Small size limits £m
Company qualification		
Annual turnover	£11.2	£2.8
Balance sheet total	£5.6	£1.4
Group employees	250	50
Group qualification		
Group turnover	£11.2 (net) (£13.44 gross)	£2.8 (net) (£3.36 gross)
Group assets	£5.6 (net) (£6.72 gross)	£1.4 (net) (£1.68 gross)
Group employees	250	50

Source: Companies Act 1985: § 247(3) and §249(3).

Where there is different activity, exclusion is limited in the UK. It is stated that where the activities of the subsidiary are so different that the consolidated accounts cannot give a true and fair view, then exclusion is mandatory.

7.4.8. *FINANCE.*

The UK equity market is the third largest in the world and the largest in Europe with a total capitalisation in excess of 98% of the GDP¹²⁰ This means that equities are more representative of the UK economy than any other European market. As companies rely heavily on the stock market for their long-term finance, published accounts have an important role to play.

Traditionally long-term finance is provided by shareholders and short-term finance by the banks that normally do not hold any equity. In many instances companies finance themselves from retained earnings. This places a strong emphasis on the need for accurate and timely published financial information for investors and potential market transactors.

Unlike the US, where the SEC is responsible for protecting the interests of investors, the financial markets in the UK are self-regulatory. The government, mainly through the Bank of England, oversees this self-regulation. The stock exchange is a private body run by its own membership (brokers). It supervises the rules for listed securities and ensures that price-sensitive information is available to all parties promptly, fairly and accurately. This includes accounting information and means that stock exchange requirements must be taken into account together with statute law.

As in other countries, there is pressure for international standards to meet the perceived need of investors in the worldwide securities markets. These investors need to be able to make comparisons among companies reporting under different disclosure regulations. This, as is shown elsewhere in this thesis, is difficult as a

¹²⁰

At end December 1992 total market value of UK and Irish equities was £629.699 billion. Individual investors account for 17% of trading value and growth in private share ownership is important for government which has sold stakes in British Telecom, British Gas, British Airways and water and electricity utilities.

result of the lack of comparability in the financial statements. which causes difficulties in listing securities and raising capital in foreign markets.

7.4.9. ACCOUNTING POLICIES, STANDARDS AND RULES.

SSAP 2 *Disclosure of Accounting Policies* sets out the four fundamental accounting concepts that underlie the preparation of financial statements. These are:

- going concern;
- consistency;
- prudence; and
- accruals.

The above, together with a fifth concept that requires assets and liabilities to be valued separately, are incorporated into the Companies Act as 'accounting principles'. Although the last mentioned concept is not a fundamental accounting concept (as per SSAP 2) it is regarded as good accounting practice.

Companies are required to publish a list of accounting policies followed in the financial statements and although these policies are determined by company law and the accounting standards there may be choices in their application. Any departures from these concepts require the directors to state the nature of such departure and the reasons and its effects on the financial statements. In certain circumstances, such as lease accounting, the economic substance of a transaction should be recognised rather than the legal form in order to give a true and fair view.

Accounting policies use national standards, which have been designed to conform as far as possible to the IASC standards. In formulating the standards the ASB constantly takes international developments into account in developing its own domestic rules. All FRSs contain a statement of compliance with IASs although the ASB has stated that it will adopt a different approach if it thinks there are good reasons for doing so.

7.4.10. NEW DEVELOPMENTS.

Changes to UK standards are driven by a wish to establish greater international harmonisation. This it attempts to do by showing its support for the IASC in its endeavour to attain an international standard. It is strengthened by the common ground between the conceptual framework of the FASB, IASC and ASB.

CHAPTER 8

AN EXAMINATION OF DISCLOSURE AND MEASUREMENT PRACTICES IN FRANCE, GERMANY AND THE UNITED KINGDOM.

8.1. INTRODUCTION.

This chapter examines the various practices through a review of annual consolidated financial statements in the three member states. In each subsection a review is made of present practice in the member states as well as the practice adopted by IASC and US GAAP. This is done in order to highlight the consistency or otherwise of current practice so that the 'coming together' of accounting standards and consequently accounting practices can be more readily determined.

8.2. AN EVALUATION OF THE MEASUREMENT AND DISCLOSURE PRACTICES USED IN ACCOUNTING FOR DEFERRED TAX.

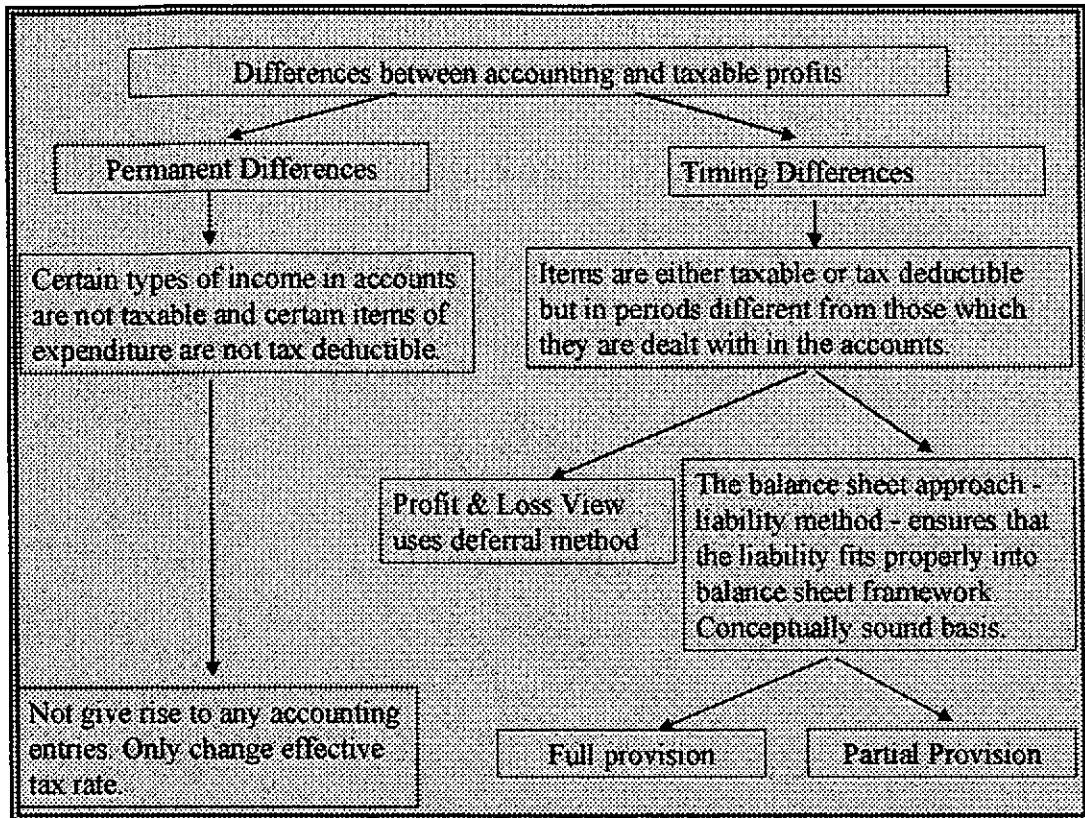
8.2.1. INTRODUCTION.

Tax is paid on the taxable profit. This can be determined from the profit shown in the profit and loss account. This profit figure can be used exactly or it may be a figure from which the ultimate taxable income is derived.

In some instances items of expenditure claimed in the profit and loss account are not allowed for tax purposes.

In other instances amounts claimed as a deduction are allowed for tax purposes but are only allowed at a later date. The tax relief and the charging to profit and loss account occur at different dates, which is said to be a timing difference.

Figure 7 Accounting profit versus taxable profit



Timing differences are the differences between taxable income and accounting income for a period. They arise because the period in which some items of revenue and expenditure are included in the taxable income does not coincide with the period in which they are included in the accounting income. Timing differences therefore originate in one period and reverse in one or more subsequent periods.

Permanent differences are the differences between taxable income and accounting income for a period that originate in the current period and do not reverse in subsequent periods.

One of the most significant areas of timing difference is that of depreciation where the charge made in the profit and loss account is added back to the profit and replaced by a capital allowance calculated under tax rules. In the earlier years of an asset's life, the capital allowance is higher than the depreciation charge and this

would result in the taxable income being lower than the profit shown in the profit and loss account. This would reverse itself in the later part of the asset's life.

8.2.2. METHODS.

There are two methods of providing for deferred tax (see Table 8.1). These methods are:

- **Deferral method:**

The tax effect of timing differences of the year is calculated under this method. The differences are charged to the profit and loss account as part of the tax charge and either debited or credited to the deferred tax account. This method ignores changing tax rates in earlier periods with the result that when the deferred tax liability falls due, it is based on the tax rate at that time and not at the time of deferral. The focus of this method is on the profit and loss account.

- **Liability method:**

The focus of this method is on the balance sheet. The liability method requires the total potential liability to be re-calculated each year using the current rates and the provision is then adjusted accordingly. The timing differences are recorded for each year and recalculated using the rates at the time of the current balance sheet.

Provision can then be made using either:

- A full provision where full cognizance is taken of all timing differences (US method); or
- A partial provision where deferred taxes are only provided for where timing differences are likely to be reversed in the near future (UK method).

Table 8.1 The methods of providing for deferred tax

DEFERRAL		LIABILITY	
Unchanging amount		Variable amount	
FULL	PARTIAL	FULL	PARTIAL

8.2.3. THE EUROPEAN DIMENSION.

Accounting for tax is dealt with in the 4th Directive by referring to its treatment in the notes (Art 43.1.10 and Art 43.1.11). The 4th Directive left member states with an option of whether or not to account for deferred tax in the financial accounts without laying down how the accounting was to be performed.

In consolidated accounts the 7th Directive (Art 29.5) allows member states to legislate to eliminate the effects of fiscal legislation.

In the FEE survey (Table 8.2 below), the lack of legislation for disclosure of deferred tax is evident especially in France where 33 out of the 34 groups did not disclose any evidence of deferred tax. In the data survey of this thesis, although there is still evidence that disclosure is not always made, all groups gave some form of disclosure either on the face of the balance sheet or in the notes.

Table 8.2 Evidence of the use of deferred tax.

	France	Germany	UK
Sample size	40	49	50
Evidence of Deferred Tax	34	29	49
Disclosed in Balance Sheet	1	3	2
Disclose in Notes	--	22	47
No disclosure	33	4	--

Source: FEE European Survey of Published Accounts (1991, p. 229).

8.2.4. INTERNATIONAL STANDARDS.

IAS 12 *Income Taxes* was revised in October 1996 and became effective after 1 January 1998. The revised IAS bans the deferral method that had been used and adopts the liability method. This method is balance sheet driven and allows, as in the case of the US, for a full provision without any discounting. Provision is made in full for all 'temporary differences' using this liability method. Tax is calculated on the temporary difference between the tax and book values.

The revised standard accrues for unused tax losses and tax credits if it is probable that they will be realised. No tax, however, is accrued for unremitted earnings of subsidiaries, associates and joint ventures. It shows a deferred tax asset if its recovery is probable.

The revised IAS provides for the recognition of more deferred tax assets and liabilities than that required under the old IAS 12. This is because the definition of temporary differences, which it captures, would not have been timing differences under the earlier standard.

8.2.5. US STANDARDS.

Under SFAS 109 deferred tax is recognised for all temporary differences regardless of when such differences are expected to reverse. A 'temporary difference' includes not only timing differences but also differences arising from non-deductible or non-taxable assets or liabilities. In the UK these differences would be regarded as 'permanent' differences.

The standard allows for the use of the liability method using rates applicable to the period in which the temporary differences are expected to reverse.

Deferred tax assets are recognised for future deductions and utilisation of tax credit carry forwards, subject to a valuation allowance.

8.2.6. FRANCE.

The treatment of this item is not very clear in French law and there is no item of deferred tax disclosed in individual accounts. It may, however, arise in group accounts through foreign subsidiaries and this fact is recognised in law.

All this is understandable because of the tax effect on individual accounts. Companies restate their group accounts to correct for any tax driven deductions, and in so doing, make the necessary provisions for deferred taxation.

In the consolidated accounts a law and decree for the implementation of the 7th Directive requires deferred tax to be recognised on a partial or full basis. Groups are allowed to use either the deferral or the liability method. It is, however, recommended that the liability method is used and that all timing differences are recognised. The most common timing differences arise from reserves that are not tax deductible until they are actually paid as, for example, pensions and any unrealised translation gains which are included in taxable income even though they are not recognised as book income. In 1987 the OEC issued support for the liability method and, with the current new approach, the CNC considers that only the liability method be recognised.

A deferred tax asset is not normally capitalised because of the operation of the prudence principle. This, however, is done where it is expected that the asset will be recovered in the foreseeable future.

8.2.7. GERMANY.

Accounting for deferred taxes in individual company accounts is rare in Germany because of the strong tax link. In large companies deferred tax assets may appear although it is unusual for companies to capitalise them because of the prudence principle.

All this changes, however, in the consolidated accounts where companies may recognise deferred assets and where any deferred tax liability must be recorded (HGB §274). No method is defined, although the liability method is the one

preferred. HGB §306 requires that timing differences (e.g. inter company profits) be addressed by accounting for deferred taxation (both a deferred asset and a deferred liability).

In using the option to account for a deferred tax asset, the group is not forced to capitalise the asset but is able to set it off against deferred tax liabilities. If the asset is recorded, profits may be distributed only if, after distribution, freely available revenue reserves plus retained profits less accumulated losses brought forward are at least equal to the amount capitalised.

8.2.8. UNITED KINGDOM.

Deferred tax is principally governed by SSAP 15, *Accounting for deferred tax*. This is an area where the UK standard and practice conflicts with the US and the IASC. As the UK standard favours a partial provision and the liability method, it features prominently in the reconciliation of UK GAAP to US GAAP (see Appendix 1).

Deferred tax in the UK was used before there were any standards. Companies used a 'tax equalisation accounting' where each period was charged with tax as determined by the profit shown. This utilised the liability method of computation. Only in 1973 when ED 11 was issued did the Accounting Standards Committee choose the deferral method and require full provision. Because of the debate both methods were allowed and the choice remained in SSAP 11. In 1977, ED 19 introduced the partial provision concept where deferred tax was only provided in respect of timing differences that were likely to be reversed. It was considered unrealistic to create provisions that would not crystallise.

Under SSAP 15, which superseded SSAP 11, provision for deferred tax is computed under the liability method. The rate used is that prevailing at balance sheet date. Tax deferred is accounted for to the extent that a liability or asset will crystallise. The liability could be permanently deferred if the company plans continued investment in fixed assets. Provision is made on reasoned assumptions whenever accounts are prepared. Debit balances of deferred tax are only carried

forward if their recovery without replacement can be foreseen. Total unprovided deferred tax is shown in a note.

Table 8.3 The history of deferred tax in the UK

	Full/ deferral	Full/ liability	Partial/ liability
ED 11 US approach	✓	✓	
SSAP 11-tax allowance that never paid		✓	
SSAP 15(1978) put in what going to pay		✓	✓
SSAP 15 (1983) problem with pensions			✓
SSAP 15 (1992) pension cost on differing basis		✓	✓
FRED 19 discounted		✓	

There is no relationship between the value of assets and their tax treatment. The amount of depreciation is unlikely to be the amount allowed for tax by way of capital allowances. Inland revenue has its own scale of allowances. When the standard was formulated there was a 100% depreciation allowance in the first year for some industrial assets, giving rise to large deferred tax provisions. Today, the differences between fiscal and company depreciation are much smaller.

In the UK, deferred tax is accounted for on a partial allocation basis, i.e. when the liability is expected within three years. It is accounted for to the extent that it is probable that an asset or liability will crystallise. This takes place when the reversal of a timing difference is not replaced by a new timing difference of at least the same tax effect. The result is that there is a decrease or increase in the amount of the tax liability. When the liability method is used the liability is calculated at the tax rate at the balance sheet date.

Having calculated the necessary provision, a liability will be included under the heading 'provision for liabilities and charges'. An analysis of deferred tax provided and not provided is also required. Where there is unprovided deferred tax then this

is disclosed by way of a note. Where a company does not provide for some or all of any deferred tax (because the directors do not consider that a liability will crystallise), the total amount of any unprovided deferred tax should be disclosed in a note, and analysed into its major components according to para 40. Disclosure can be made of the full deferred tax benefit of funding pension and other post-retirement costs.

Deferred tax carried forward as an asset is usually part of debtors. Tax assets are recognised if recoverable. In the case of tax losses they can be recorded provided there would be sufficient future taxable profits to offset current losses. Deferred tax assets relating to pension provisions can be recognised in full subject to recoverability.

Both the Act and SSAP 15 require any provision for deferred taxation to be shown separately. The deferred tax balance, its major components, and transfers to and from the deferred tax account should be disclosed in the notes as required by para 37 and para 38.

8.2.9. THE FUTURE.

SSAP 15 is currently being reviewed as being out of line with international practice. Under the review the debate is if the provision for deferred tax should be made on a full or partial basis.

It is suggested that the partial provision method is subjective, relying heavily on management expectations about future events. It is also inconsistent with other areas of accounting and has lost favour internationally. But past criticism was that it could lead to a build-up of large liabilities that may fall due only far into the future. The view is that the problem is mitigated by discounting the deferred tax liability so that a smaller amount is dealt with in the accounts.

Elliott and Elliott (1999, p.222) cite examples from Smith (1996). They show that if full provision for deferred tax were made then earnings per share would fall, as in Table 8.4 below:

Table 8.4 Effects of the use of a full provision for deferred tax on EPS

Company	Decrease in EPS
British Airways	36.4%
Severn Trent	25.3%
British Gas	20.5%

Source: Smith (1996) cited by Elliott and Elliott (1999, p.222).

'The Board [ASB] does not wholeheartedly agree with the criticisms levelled against the partial provision method. But it accepts some of the arguments made against it and is committed to international harmonisation.' The report of the FRC (1999, p.29) goes on to record that 'deferred tax is not one of the areas where a good case can be made for taking a stand against the direction of international opinion' and therefore believes the UK should move to full provision.

FRED 19 which was brought in during 1999, does however differ with IAS 12 and proposes:

- No deferred tax on revaluation gains or in respect of tax that would be payable if overseas profits were remitted to the UK.
- Long-term deferred tax balances should be discounted if the effect is material. IAS 12 specifically prohibits this practice.

The discussion paper FRED 19, *Deferred tax*, follows the change in SFAS 96. It is evident that applying the full provision method is more consistent with international practice and the ASBs Statement of Principles.

8.2.10. REVIEW OF SAMPLE GROUPS.

Although the determination of a company's tax liability is based on the reported profit, tax laws allow that certain items are recognised for tax purposes at different amounts or over different periods. These differences between taxable and accounting profits are the amounts of deferred tax and any user of financial

statements needs to have knowledge of national accounting standards in order to be able to understand and gauge the way in which this item is treated in the accounts. This is considered important because deferred tax could be a significant percentage of equity.

The international issue is how should deferred tax be recognised and should it focus on timing differences or on temporary differences. The former is the so-called profit and loss account approach while the latter is the balance sheet approach. It is the latter that has been adopted by IAS 12 (revised) which also accounts for deferred tax in full.

8.2.11. FRANCE.

In an examination of the groups within the sample all made use of the liability method and, with the exception of Lafarge, provided for full deferral. It is interesting that Lafarge (which uses IAS) qualified its report by stating that it is not making use of the provisions of IAS 12 (revised). While providing for deferred taxes using the liability method Lafarge only used a partial provision. The notes refer to the group 'suspending' the use of IAS 12 as from 1 January 1998. It is under this 'suspension' that the partial provision method has been used.

The fact that full deferral is used by the remaining companies seems to accord with the OEC recommendations which also conform to the requirements of IAS 12 (revised).

In a country where prudence could be said to be a dominating force, it is noticeable that 7 of the groups also disclose a deferred tax asset.

In the case of Eridania, the provision is made on a full basis but there is a note that IAS 12 was not applied for recording the provision for deferred tax on contingencies. Had it been applied then the provision would have amounted to an additional amount of FFr 970m. This would have the effect of increasing the percentage of the provision from 1.53% to 5.82% of equity.

8.2.12. GERMANY.

Although there was a lack of disclosure in many cases, the groups that did disclose deferred tax indicated that the liability method had been used. The extent of the provision was variable with a number of groups and did not conform to the practices advocated by the relevant GAAP. BASF and Degussa, where US GAAP had been adopted, indicated the use of the partial provision. Bayer (IAS standards); Daimler (US GAAP), and Preussag (German GAAP) all used a full provision. In all the other cases there was no indication of the extent of the provision.

In the case of a deferred tax asset there was disclosure by four groups. In all these cases the groups had adopted either US GAAP or IASC standards.

8.2.13. UK.

A very consistent use of the liability method coupled with a partial provision was shown by all groups. Both the Companies Act and SSAP 15 require any provision for deferred taxation to be shown separately. The deferred tax balance, its major components, and transfers to and from the deferred tax account should be disclosed in the notes as required by para 37 and para 38.

Eight of the groups include the deferred tax item with the provision for liabilities and other charges while in one instance, BP Amoco, it is shown as a separate item on the face of the balance sheet. In all instances this meets the requirements of the standard for a separate disclosure. Where disclosed there is no provision for overseas subsidiaries or the disposal of properties.

In the case of Pennon, it is stated that no provision is considered necessary although the amount of deferred tax is disclosed by way of note.

When calculating the percentage of deferred tax disclosed under 'provision for other liabilities' this varies from 0.19% to 37.43% with an average of 11.92%.

The percentage of deferred tax to equity varies from 0% in the case of Pennon to 118.59% in the case of BNFL. If full deferral is brought into account then the relevant percentage is 3.55% to 479.69%.

In the case of BNFL, the group records that deferred tax has been provided in full. This seems to be contrary to the UK standard, which only indicates a provision on a partial basis.

8.2.14. A REVIEW OF THE RESULTS.

Lesson 1.

In examining the three countries it is important to ascertain if the rules or policies adopted are similar or different. What must be determined are the issues by which deferred tax arises in the country.

Where there is a tax link, then it becomes apparent that there would not be any need or, in fact, any accounting for deferred tax, as the profit shown in the profit and loss account is that used by the tax authorities. It is only where there is no direct tax link that the issue becomes of importance.

It should be noted that there is a de jure and de facto choice. All this can mask the fundamental differences to the topic.

Lesson 2.

There are situations where any MNC may exclude certain entities in the consolidated accounts. Where this is a German or French group then the disclosure may show that there is no deferred tax provision in the group accounts. This is brought about because of the exclusion of the individual accounts or because there may be minor assets, which are not recorded.

Lesson 3.

Deferred tax is an example of how important accounting policies have different levels of significance. The difference between the liability and deferred methods is

trivial unless a country has a fluctuation in the rate from year to year. In the case of full versus partial provision the analysis shows that this will increase liabilities and reduce equity values. It is observed that the average change in percentage of deferred tax to equity increases from 20.49% under the partial provision method to 68.58% in the case of full provision.

Lesson 4.

There is evidence that analysts regard the flexibility of UK rules on deferred tax as open to abuse. The flexible policy can operate as a signalling mechanism to which analysts are sensitive, especially those astute analysts. They may well see that the management choice of income boosting accounting policy is a sign of nervousness and sensitivity to corporate performance.

Consequently the accounting environment in which such flexibility is possible may give rise to useful signals to the analyst community.

Classification systems based on the de facto position will not capture the importance of this unless they both report the accounting policy choice made and also measure its impact. All studies based on de facto measurement fail to do the latter.

Lesson 5.

It may well be that the issue of deferred tax highlights the importance of the complication of adding subsidiaries from various countries.

Lesson 6.

One problem is what is full provision and what is partial. There is a non-provision in the UK only if there is a partial provision. But contrast this to the case where deferred tax assets are common. It is not clear if a write down of the asset should be regarded as a form of partial provision or an exercise of prudence.

Lesson 7.

It is not possible to classify countries because of the problems of determining the differences in measurement.

8.3. AN EVALUATION OF THE METHODS ADOPTED AND DISCLOSED IN FOREIGN CURRENCY TRANSLATION.

8.3.1. INTRODUCTION.

Foreign currency translation is a topic of significant economic importance as a result of the rapid expansion of multinationals. It refers to the process of restating accounting data recorded in one currency into another for the purposes of aggregating data from different reporting entities. The most common use is in the presentation of consolidated financial statements where the accounts of overseas entities are consolidated with the holding company. Important too, is that this process must not alter the way in which the assets and liabilities are measured but rather restate them to a common currency. The method used should reflect the financial and other relationships that exist between the holding company and the foreign enterprises, be they a foreign subsidiary, associated company or branch. Foreign enterprises are generally separate entities, which conduct their affairs in local currency and are financed locally. As a result they are not dependent on the investing company's currency. The risk, therefore, is the net worth of the investment and not the individual assets and liabilities.

Unlike foreign exchange transactions, foreign currency translation does not involve actual currency exchanges. The foreign currency translation gains and losses result from a restatement of all foreign subsidiary accounts for consolidation in the parent company's financial statements. When exchange rates are fairly constant the process is relatively simple. It is the fluctuations that dictate the need for a method of translation so that the effects of rate changes can be measured. The question is which rate and how are the gains and losses treated in the accounts.

8.3.2. *METHODS.*

In preparing consolidated financial statements the common methods used to translate amounts from different foreign currencies to the domestic or functional currency are:

- The closing (current) rate method.

This is the easiest method to apply and due to its simplicity is the most popular translation method in practice world-wide. This method merely restates the foreign currency financial statements into the reporting currency. In this method all assets and liabilities are translated using the closing rate. No agreement exists in respect of the profit and loss account and as such either the closing rate or the average rate can be used. Once this is done, there is a difference on exchange which reflects the restatement of the opening net investment figure and the profits (or losses) of the subsidiary. But this difference is not something, which impinges on the parent company's cash flow, and therefore the difference is taken through the parent company's reserves and not the profit and loss account.

Accounting principles used by the foreign subsidiary are not changed for translation. This gives recognition to the fact that the foreign subsidiary operates in an environment different from the one in which the parent company operates. The original financial ratios in the foreign currency are also unaffected by the translation because the account balances in the foreign currency are multiplied by a constant rate. In essence, this method preserves the flavour of the local environment of the foreign subsidiary.

- The temporal method.

This method retains the original measurement bases of the items in the foreign currency, since it uses the exchange rates in effect at the dates when the measurements in foreign currency amounts were made. The objective is to translate assets and liabilities in a manner that will keep their measurement base at the dates of original transactions. Under the temporal method, currency

translation is viewed as a restatement of the financial statements.

Money assets and liabilities are translated at closing rate but non-monetary assets are translated at the date of the transaction (historical rate). In the case of profit and loss items they can be translated at the actual rate or average rate, with differences going to the profit and loss account.

The temporal method is used where the foreign trade is an extension of trade of the parent company and the results are more dependent on the economic environment of the investing company's local currency than its own reporting currency. In this case the transactions are treated as though they were made by the investing company and the rate used is the one at the date when the transactions occurred.

The application of this method results in the following:

- Monetary assets and liabilities are translated at the year-end rate on the balance sheet date.
- Non-monetary assets, liabilities, and equity are translated at the historical exchange rates that were in effect when those assets were acquired, liabilities were incurred, and capital was contributed.
- Most revenues and expenses are translated at a weighted average rate for the period. Cost of goods sold, depreciation expense, and amortisation expense are translated at the appropriate historical exchange rates.

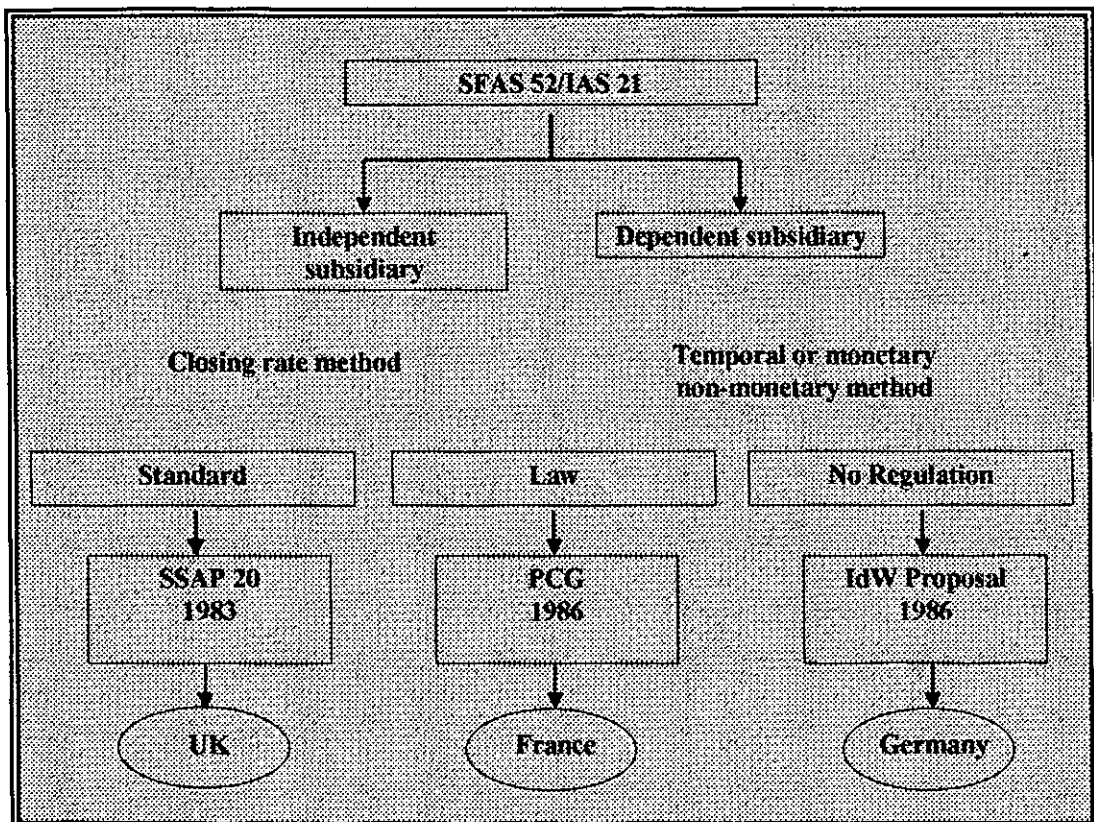
All transaction gains and losses are taken directly to profit and loss account and, therefore, affect the income reported for the period. It is notable that this did not find favour in the UK or the US.

While the closing rate method does achieve the objective of reflecting the financial results and relationships, the use of the average rate reflects more fairly the profits and losses and cash flows as they arise to the group throughout the period.

8.3.3. THE EUROPEAN DIMENSION.

Neither the 4th Directive nor the 7th Directive deals fully with foreign currency translation. The only requirement – that there is disclosure in the notes of the method used for translation – is dealt with in Art 43.1.1 of the 4th Directive and Art 34.1 of the 7th Directive. The omission is significant, as, without a fixed rule, the application of different methods leads to differences in accounting practices and a corresponding lack of harmonisation (see Fig 8 below).

Figure 8 The translation of foreign financial statements in Europe



Extract from Flower and Lefebvre (1997, p.328).

The only guidance given is that by the 4th Directive working party,¹²¹ which recommended *inter alia* that the temporal method be used when an enterprise was an integral part of the parent company. Under this method any resulting positive and negative translation differences would be included in the profit and loss account (para 27).

The results of the FEE survey (see Table 8.5 and Table 8.6), show significant de facto levels of harmonisation. This could, however, arise because of the effect of the adoption of an international standard into consolidation practices. In spite of this, there are still areas of differences and in levels of disclosure. Without question, there is the constant risk to which companies may be exposed in the foreign exchange arena and without adequate disclosure, the user is unable to assess that exposure.

In areas of high inflation the Accounting Advisory Forum (1995, para 37) stated that groups should adjust the local accounts to take account of the effects of inflation on the results before translating those accounts at the year end rates.

Table 8.5 The use of the main methods of foreign currency translation of balance sheet items.

	France	Germany	UK	Total
Sample size	22	49	50	121
Foreign operations	18	36	36	90
Closing rate	14	19	33	66
Temporal	-	9	-	9

Source: 1992 FEE European Survey of Published Accounts, p.210.

Table 8.5 above shows that Germany uses the temporal method in addition to the closing rate method, while in both France and the UK only the latter method is used. In other studies (see Nobes and Parker, 2000, p.358), it is shown that 65% of German companies use the closing rate while the rate increases to 87% in the case of France.

In the review of the sample groups, the pattern of the method used for the consolidated balance sheet remains the same.

¹²¹ Accounting Advisory Forum on Foreign Currency Translation, (1995, para 34).

Table 8.6 The use of the main methods of foreign currency translation of profit and loss items.

	France	Germany	UK	Total
Foreign operations	18	36	36	90
Profit and loss account at Closing rate	9	11	11	31
Profit and loss account at Average rate	5	21	18	44
No disclosure	-	3	1	4

Source: 1992 FEE European Survey of Published Accounts, p.210.

In the case of the profit and loss account, a movement to the average rate is evident.

8.3.4. INTERNATIONAL STANDARDS.

IAS 21, *The Effects of Changes in Foreign Exchange Rates* was revised in 1993 to remove options and sets out the principles that are to be used. Foreign operations are either an integral part of the reporting enterprise or are a separate foreign entity. In the latter instance the functional currency of the foreign enterprise is the currency in which it operates. In preparing consolidated accounts, the balance sheet should be translated into the reporting currency using the closing rate while the profit and loss account is translated using the average rate. All exchange differences are written off to equity and included subsequently in any gain or loss on the disposal of a subsidiary.

IAS 21 requires that reports in the currency of a hyperinflationary economy must be restated in accordance with IAS 29. The restatement to be made is to current price levels, which allows a correction for the effects of inflation. All non-monetary assets and liabilities are restated to current values at the balance sheet date using an appropriate price index, which must be disclosed. Monetary assets and liabilities are not affected as they are stated at the balance sheet date. Any net gain or loss must be disclosed in the profit and loss account. This is done prior to translation

into the reporting currency using the closing rate. This practice conflicts with SFAS 52 (see 8.3.5 below).

Many foreign entities that operate in hyperinflationary economies prepare their financial statements in a stable currency. In these cases there is no need to restate the financial statements before they are translated into the reporting currency.

8.3.5. US STANDARDS.

In the United States, foreign currency translation is the one area where foreign companies are allowed to follow IAS 21 instead of SFAS 52. This is allowed because SFAS 52 is comparable to IAS 21 in that it uses the closing rate method but also allows for the use of the temporal method.¹²² The use of the two methods depends on the foreign enterprises functional currency. If the functional currency is the local currency of the country where the subsidiary is domiciled, then the closing rate method is used. If not, then the temporal method is used.

SFAS 52 defines functional currency as the primary currency in which the subsidiary conducts its business.¹²³ Although the definition appears simple, its application requires that various factors must be considered when determining the functional currency. These factors could include cash flow, sales price, sales markets, expenses, financing, intercompany transactions and arrangements.

Although SFAS 52 is comparable to IAS 21 it is at a variance with IAS 29 when dealing with subsidiaries in hyperinflationary countries. When the operations of a subsidiary are closely tied to the US dollar or when the subsidiary is located in a country with a highly inflationary economy, the financial statement of the foreign subsidiary must be remeasured before they are translated.¹²⁴ This view, by the US, assumes that the use of the local currency is inappropriate. As a result, in many hyperinflationary economies, a base currency other than the local currency is used

¹²² IAS 21 was based on SFAS 52.

¹²³ FASB (1993) 'Original Pronouncements', Accounting Standards 1, Norwalk, CT: FASB, p.501.

¹²⁴ SFAS 52 does not use the term 'temporal method' but refers to it as 'remeasurement'.

as the store of value even when the local currency is required to be used as the unit of account.

When using the closing rate method for balance sheet translations, SFAS 52 stipulates that in the case of the profit and loss account, the average rate is used. This application is different in the UK where use can be made of either the average rate or the closing rate.

8.3.6. FRANCE.

France has national legislation, which identifies and limits the methods to be used. The translation methods are set out by the decree of 29 November 1983 for single entities and by the decree of 17 February 1986 for consolidated accounts. Specific provisions are contained in the PCG. In single accounts the closing rate method is used and translation differences are deferred and placed in an account called *écart de conversion*. Unrealised gains are not shown as a profit but can be used to provide for unrealised losses for which a provision for risks is created. It is possible to include both unrealised gains and unrealised losses in the consolidated profit and loss account.

Due to that fact that no set method was stated in the 1986 rules, foreign currency translation has not been an issue in France. Evidence (see Table 8.7) shows that the majority of companies examined apply the closing rate method for balance sheet items. These same companies are shown to use the average rate for items in the profit and loss account. This is further supported by a later survey as detailed in Table 8.9.

Table 8.7 Results of Survey of Large French Groups

Sample size	100
Groups with foreign subsidiaries	100%
Groups using closing rate	87%
Groups using historical rate	9%
Groups giving no information	4%

Extract from Cauvin, Angleys and Saint Pierre (1996), *L'Information Financiere*, CPC Meylan, p.210. Cited by Nobcs and Parker (2000, p.358).

To incorporate foreign entities into the consolidation, the PCG allows the use of two methods - the temporal method or the closing rate method. The former is used if the entity is an integral part of the parent's activities while the closing rate method is used when it is an independent entity.

In the case of entities affected by hyperinflationary economies these are dealt with in the same way as prescribed by IAS 29.

As required in the 4th and 7th Directives, the methods used to translate the financial statements of foreign entities should be disclosed in the notes accompanying the consolidated financial statement.

8.3.7. GERMANY.

There are no specific requirements for the translation of foreign currency financial statements in German law or accounting principles. There have been pronouncements from the professional bodies in Germany but they differ, especially regarding the method of treatment of translation gains. Thus, consistency in the use of a translation method and its disclosure, are still required.¹²⁵ Flower (2000, p.360) concludes that the 'lack of agreement over the rate to be used for the

¹²⁵ IdW(1986) suggested the closing rate and the temporal method without linking the use to the degree of intergration of the subsidiary.

profit and loss account is a clear indictment of the lack of theoretical basis for the closing rate method.⁷

In an earlier study Flower and Lefevre (1997, p.336) show that Germany is the one country where use is made of methods other than the closing rate. The sample used in their study showed relative harmony in practice with the dominant use of the closing rate method (76% in 1987 and 75% in 1993). When the closing rate was used for the balance sheet items then the average rate was used in the profit and loss account (71% and 82% in 1993). It was noted that German companies applied a variety of methods and also combined them in many ways. For example: [1] Use was made of the functional currency approach by for example BASF (1993). This method included a 'modified' temporal method. [2] The temporal method was also used where translation differences were not reflected in the profit and loss account. An example given here was of Bayer (1993). [3] In other cases use was made of the current/non-current method by, for example, Daimler (1992).

In practice, either the closing rate method or the temporal method is used for the translation of financial statements of a foreign operation. This is illustrated in Table 8.8 below. The method selected usually determines the treatment of the foreign exchange gains or losses. Germany considers this translation process as a valuation issue and, in order to comply with HGB §252, only realised profits are taken into account together with all losses.

Table 8.8 Results of Survey of Large German Groups

Groups with foreign subsidiaries	100%
Groups using closing rate	65%
Groups using some form of non-current rate *	22%
Groups giving no information	13%

C&L Deutsche Revision, 1997, Konzernabschlüsse '95, IdW-Verlag, p.177
Cited by Nobes and Parker (2000, p.358).

* For example- valuing assets at the lower of the historical rate and the closing rate.

The above shows a significant use of translation methods based on historical rates.

If the temporal method is used, exchange adjustments are generally recognised in the profit and loss account. In cases where the closing rate method is used, the exchange gains or losses are usually included in equity. The amounts of exchange gains or losses are not normally shown separately in the financial statements.

Ordelheide (1995, p.1596) considered that 'the variety of methods used in practice impairs fundamentally the comparison between groups on the basis of their annual accounts, notably for quoted undertakings.'

The Accounting Advisory Forum (1995a, para 34) suggested that there be a distinction between integrated and non-integrated operations and that the former use the temporal rate and the latter the closing rate.

In spite of this Flower and Lefevre (1997, p.336) conclude that few companies distinguished between integrated and non-integrated subsidiaries. This is re-enforced in the sample reviewed where it is noted that unlike France and the UK, no distinction is made between an integrated and non-integrated foreign operation for translation purposes.

8.3.8. UNITED KINGDOM.

SSAP 20 *Foreign Currency Translation*, states that the closing rate method should be used unless the trade of the foreign enterprise¹²⁶ is more dependent on the economic environment of the investing company's currency than its own, when the temporal method should be used. The standard, published in 1983, followed the US position as set out in SFAS 52.

When using the closing rate method, then in the case of profit and loss account balances they are translated either at closing rate or average rate and any exchange differences are charged to reserves.

¹²⁶ This standard refers to 'foreign enterprises' and not related companies as the rules relate not only to subsidiaries but also to associates and foreign branches.

Financial statements of integrated foreign operations are translated using the temporal method. Any gains or losses arising from translation are shown in the profit and loss account of the current period. Differences are treated as if they were transactions of the parent. In the Balance sheet, non-monetary assets are translated using historical cost while other assets and liabilities use the rate at balance sheet date. In the profit and loss account the rate used is that at the time of the transaction but depreciation is translated at the historical rate. 'Therefore, it is normally appropriate..., to recognise such gains and losses as part of the profit or loss for the year, they should be included in profit or loss from ordinary activities unless they arise from events which themselves would fall to be treated as extraordinary' (Para 8). 'It is therefore inappropriate to regard them (exchange differences) as profits or losses and they should be dealt with as adjustments to reserves' (Para 19).

Unlike the practice adopted by the US or by the IASC, no transfer is made from reserves for gains or losses on disposals. This is in accordance with FRS 3 *Reporting Financial Performance*, which states that reserves are not returned. Exchange differences between the opening and closing balance sheet amounts and the difference between the balance sheet at closing rate and the profit and loss account using average rate, are all shown as a movement on reserves. Under FRS 3 these movements are to be reported in the statement of total recognised gains and losses (STRGL) and not the profit and loss account.

The accounting standard requires that disclosures be made of:

- Translation methods used.
- The amount of translation gains or losses taken to equity during the current period.
- The amount of translation gains or losses included in income in the current period.
- The net movement on reserves attributable to exchange differences.

In hyperinflationary economies SSAP 20 requires that local currency accounts be adjusted to reflect current price levels before translation. While this requirement is in conformity with IAS 21, it is the main difference between SSAP 20 and SFAS 52.

Where a foreign enterprise operates in a country in which a very high rate of inflation exists it may not be possible to present fairly in historical cost accounts the financial position of a foreign enterprise simply by a translation process. In such circumstances the local currency financial statements should be adjusted where possible to reflect current price levels before the translation process is undertaken. (Para 26)

In spite of this statement the standard does not show how this is done.

UITF 9 deals with accounting for operations in hyperinflationary economies and brings UK practice closer to SFAS 52. It sets out two methods to eliminate the distortion, which it considers are consistent with SSAP 20.

In the first method the local currency financial statements are adjusted to reflect current price levels before translation is undertaken. Any gains or loss are taken to the profit and loss account. This is the method adopted by IAS 29.

The alternative method suggested is that a stable (non-local) currency is designated as the functional currency into which the foreign subsidiary accounts are translated using the temporal method. This is undertaken before the accounts are translated into the parent company's currency. In the words of UIFT 9 'the effect is that the movement between the original currency of record and the stable currency is used as a proxy for an inflation index.' Any differences in the translation are recorded in the profit and loss account.

Table 8.9 Translation of foreign financial statements

	France		Germany		United Kingdom	
	1987	1993	1987	1993	1987	1993
Number of companies	15	24	28	27	25	42
Closing rate	14	21	9	17	25	42
Temporal method	--	--	2	2	--	--
Current/non current method	--	--	5	4	--	--
Combination of methods	1	--	3	3	--	--
No disclosure	--	3	9	1	--	--

Extract from Flower and Lefebvre, (1997 p.337)

8.3.9. REVIEW OF SAMPLE GROUPS.

In reviewing the methods adopted by IASC standards, UK GAAP and US GAAP, it is observed that they all take broadly the same approach. In fact, on the analysis of practice by the groups reviewed, it could be stated that both France and Germany also identify with an identical approach.

1. For translation of balance sheet items, the closing rate method is normally applied. While there is evidence of the temporal method being applied, it is only used where the subsidiary is effectively an extension of the parent company's activities.
2. In areas of hyperinflation there is a distinction between the practice in the UK and the US. In the UK the approach is to translate the accounts of the foreign subsidiary and then use the closing rate method. In the US this is not the practice and the temporal method is used. A diversified practice is also evident in both France and Germany where both the methods are used.

Having stated that all three member states showed consistency in their approach to translation, it was observed that in Germany there was a mixed use of the closing rate method and the temporal method. This may well be because of the German adoption of the 'prudence' concept. As a result the rates used could give a lower value in each case.

Where groups used US GAAP or IASC standards then the closing rate method was used and the adjustments were written off to reserves. Groups reporting under German GAAP, however, varied in what they used - some using the temporal method and others using the closing rate method. In all instances, however, the write off was to reserves.

8.3.10. FRANCE

In France all the groups examined indicated that they had used the closing rate method for translation and the average rate for profit and loss account items although, in two instances, the profit and loss account treatment was not disclosed. All translation adjustments were written off to reserves. There were no indications by any of the groups of the method that they would use if the subsidiaries were integrated with the parent company. It must be assumed therefore, that all group companies are autonomous and use their local currencies as the functional currency.

The only area of currency translation where there was some alternative accounting treatment in France, was in the case of subsidiaries in hyperinflationary economies. In some instances the foreign subsidiaries were subject to an inflationary adjustment to reflect current price levels. This was noticeable in the case of groups that had adopted IASC standards (IAS 29). It was also evident in Legrand where US GAAP was followed. This latter case is in conflict with the known facts. It is the one area where US GAAP and IAS 21 are not 'ad idem' and therefore it would be considered that an identical practice would not apply.

In a review of the French groups, the only evidence of the use of the temporal method in a hyperinflationary economy was in the case of France Telecom. In this

case certain subsidiaries made use of the US dollar as the stable currency. The group noted that in these cases the statements were translated in the same way as any of their other subsidiaries, i.e. using the closing rate method. In other instances where the local currency has been maintained, then the temporal method was used.

8.3.11. GERMANY

In examining Table 8.5 it is noted that there is a mixture of usage of the temporal and closing rate methods. This is further evident in the examination of the data sample later in this section (see Table 8.9). Using the sample of group financial statements it is noticed that only in Germany is use made of the temporal method and this is only done when an accounting standard, other than that under German GAAP, is used. Of the ten groups examined, three of them show evidence of using the temporal method, of which one, Bayer, uses IASC standards while the other two, BASF and Degussa, apply US GAAP. This use of the temporal method is in addition to the use of the closing rate method.

Translation of the profit and loss accounts used average rates and there were no instances of the closing rate being used. This is at variance with the findings of the FEE (see Table 8.6), where 30% of the German groups showed evidence of using the closing rate method in the profit and loss account.

It was in the treatment of subsidiaries in hyperinflationary areas that the practice was found to be varied with some groups using the temporal method and others using an inflation adjustment. No pattern emerged as to the method of use coupled to the GAAP being applied.

In the case of BASF the group stated that the temporal method is used where the deutsche mark is the functional currency. Although no definition is given of what this means it is implied that the use of the wording is in line with the definition in SFAS 52.

Bayer, using IAS 21, states that the majority of its subsidiaries are financially, economically and organisationally autonomous. The functional currencies are the

local ones and for this reason the closing rate method is used. When the foreign company is an integral part of the parent company, then the temporal method is used. The group gives a full explanation of this method in the notes. The group also advises the user that subsidiaries in hyperinflationary countries prepare their accounts in a stable currency and once this is done the translation to deutsche mark makes use of the temporal method. This latter practice conforms to IAS 29.

Degussa records that this is first time that its subsidiaries are translated according to the functional currency concept. This 'first time application' is also noted by Preussag. Neither group indicates if all the subsidiaries have been brought into the consolidation through the use of the closing rate and/or temporal method. The only stipulation made is that they have been brought into account and that translation has been applied using the functional currency concept. In the case of Preussag it does note that subsidiaries in hyperinflationary countries are brought into account using the inflationary adjustment method.

Both Daimler and Veba imply that all their subsidiaries have used local currencies as their functional currency and as a consequence they do not deal with the translation method that may be used where the subsidiaries have the deutsche mark as their currency.

AGIV uses what is described as a modified closing date rate. Under this method the translation of equity is at historical rates while the depreciation costs and net income are translated at balance sheet date.

Although Audi has a foreign subsidiary in Hungary, the accounts are prepared there in DM and as a result, there is no need for translation. No statement is made about any other translation in the accounts.

In the case of Deutsche Babcock there is no disclosure as to whether all subsidiaries are taken into account using the closing rate method. The financial report talks of international companies but does not indicate if they are independent of the parent company.

The financial statements of Hochtief disclose that currencies used in the consolidation include the Brazilian real and the Argentinan peso. Although both countries had, in the past, been classed as hyperinflationary countries, this clearly no longer applies. This evidence is also shown in the case of Peugeot.

8.3.12. UK.

In the UK the pattern applied to currency translation was in conformity with SSAP 20. In all cases the closing rate method was applied to the balance sheet and the average rate to the profit and loss account. Differences were written off to reserves. Only one group, BAT, showed evidence of a subsidiary in a hyperinflationary country and in this case the temporal method was used.

It must be assumed that all subsidiaries are autonomous operating undertakings and that the failure to mention the temporal method is because there are no integral undertakings to which this method could apply.

8.3.13. A REVIEW OF THE RESULTS

All three member states showed a high degree of uniformity in their approach to this topic, although in each country there were differences in the method of accounting for subsidiaries in hyperinflationary economies. Either method was used and, although IASC standards advocate the use of inflation adjustments, it was noticed, in the case of Bayer, that the group there made use of the temporal method by undertaking the local inflation adjustment first.

Table 8.10 Results of Survey of Sample Group

	France	Germany	UK	Total
Evidence of Foreign Entities	11	10	10	31
Closing Rate for Balance sheet items	11	9*	10	30
Average rate for profit and loss account	9	7	9	25
Closing rate for profit and loss account	-	-	1	1
No profit and loss account disclosure	2	3	-	5

*Three of the groups also use the temporal method.

8.4. AN EVALUATION OF THE DISCLOSURE PRACTICES MADE ON GOODWILL.

8.4.1. INTRODUCTION.

Goodwill is defined in FRS 10 as 'the difference between the cost of an acquired entity and the aggregate of the fair values of an entity's identifiable assets and liabilities.' It is conceivable that the goodwill figure when determined can be either a positive one or a negative one. In some acquisitions the fair value of the identifiable assets acquired will exceed the fair value of the consideration given for the acquisition. In such a case negative goodwill arises. Some of the reasons for this negative goodwill are, because of a forced sale where the undertaking acquired is in liquidation; due to the negotiating skills of the purchaser when agreeing the price; because the workforce is poorly motivated and the business has been performing badly as a result and because it is anticipated that losses will be incurred by the acquired business in the future.

Where the entity is acquired for an amount in excess of the aggregate of the fair value then there is a positive goodwill, which is required to be treated in various

ways, as described in the section below. Conversely, in the case of negative goodwill its treatment is also more explicitly dealt with below.

This analysis and evaluation only deals with goodwill as a result of group consolidation. Goodwill only arises from a transaction of purchase and internally generated goodwill is not taken into account.

Purchased goodwill is based on transactions with a third party, at arm's length, and, for financial reporting purposes, it is normal accounting practice that only this form of goodwill should be recognised in the accounts.

The question that arises is how is the measurement of goodwill achieved?

Using what has been described as the 'Anglo American method' the purchase price is compared to the fair values of the identifiable assets and liabilities and any excess (or deficit) is termed 'goodwill'.

The alternative method, described as the 'modified continental European method', compares the book value of net identifiable assets to the purchase price and if, as a result of this, an amount of negative goodwill is shown, then this amount is dealt with as described later under negative goodwill. If, however, the amount reflects a positive goodwill, then there is a possibility of revaluing the assets, but this would be limited to the value of the goodwill.

8.4.2. METHODS.

Once the goodwill has been determined, it is then brought into the accounts at the time when the parent company and the acquired entity are consolidated. Once this is done there are different methods that could be used in dealing with this purchased goodwill. It could be capitalised and amortised over a fixed period or it could be written off immediately to either profit and loss account or reserves. This latter practice is utilised as it avoids the drag on future earnings, which would be caused by the process of amortisation.

8.4.3. THE EUROPEAN DIMENSION.

Art 9 and Art 10 of the 4th Directive require that goodwill be disclosed to the extent that it was acquired for a valuable consideration. Art 37.2 allows for goodwill to be written off systematically over a period not exceeding its useful economic life. Where the period is in excess of 5 years it is to be shown in the notes with reasons.

The 7th Directive also deals with goodwill in articles 19, 30 and 31. While it allows for the immediate deduction of goodwill from reserves, it also provides for disclosure as a separate item in the consolidated balance sheet. It allows any group within a member state to offset positive and negative goodwill but this must be disclosed in the notes.

In the FEE survey (1992), (see Table 8.11) it shows that at the time of the survey the disclosure of goodwill by France and Germany was fairly consistent while the UK still wrote off goodwill immediately.

Table 8.11 Disclosure of capitalised goodwill on consolidation

	France	Germany	UK
Sample of companies	22	37	48
Evidence of goodwill	21	35	43
Evidence of capitalised goodwill	21	21	3
Disclosed in balance sheet	14	2	--
Disclose in notes	8	21	3

Source: 1992 FEE analysis of European Accounting and disclosure practices, p.85

In Table 8.12 the results of the FEE survey are extrapolated to reveal the time period over which goodwill was amortised.

Table 8.12 Amortisation of capitalised goodwill on consolidation

	France	Germany	UK
Evidence of capitalised goodwill	21	21	3
Amortisation over more than 5 years	12	3	3
Amortisation equal to or less than 5 years	3	4	--
No Disclosure of Amortisation Period	6	14	--

Source: 1992 FEE analysis of European Accounting and disclosure practices, p.87

The varying periods of amortisation is dealt with in more detail, in the case of France, in a further survey (see Table 8.12). This area is still one of ongoing diversity. In a latter review of the sample groups this aspect of goodwill is considered in more detail (see 8.4.9).

8.4.4. INTERNATIONAL STANDARDS.

Under the revised IAS 22 *Business Combinations*, goodwill, being the excess cost of acquisition over the net acquired identifiable assets and liabilities, is capitalised and amortised over its useful life. One of the main changes in the 1998 revision to IAS 22, which became effective from 1 July 1999 is the rebuttable presumption that the useful life does not exceed 20 years. Previously this 20-year period was an absolute limit.

Where evidence can be shown of a useful life in excess of 20 years, (the standard does not allow for an indefinite useful life),¹²⁷ then the enterprise must carry out an annual impairment test as set out in IAS 36 and disclose why the useful life is considered to be in excess of 20 years.

¹²⁷ The useful life is 'always finite' (para51). The IASC rejected the ASB approach where it is possible to have an infinite life provided the company undertakes an annual impairment test. The IASC states that goodwill should always be amortised and tests should not be used as a replacement for a systematic allocation of cost (see para 46 on the basis for conclusions).

IAS 22 (revised) only allows a single treatment for negative goodwill. If negative goodwill relates to expectations of identifiable future losses and expenses, which can be measured reliably but are not liabilities at the acquisition date, that portion should be deferred and recognised in the profit and loss account when those future losses or expenses occur. Where it does not relate to future losses and expenses, then the negative goodwill is recognised via the profit and loss account over the useful life of the non-monetary assets acquired but only to the extent that the negative goodwill does not exceed the fair values of the non-monetary assets. Any excess negative goodwill is shown as income immediately.

8.4.5. US STANDARDS.

The requirements under SFAS 121 are similar to those of the UK for the allocation of the purchase price to identifiable assets. The period of amortisation allowed is 40 years.

In the case of negative goodwill, this is written off proportionately against non-current assets thereby reducing the value assigned to them. If there is a balance after reducing non-current assets to zero, then this is shown as a deferred credit and amortised to income on the same basis as goodwill.

The SEC allows foreign registrants to adopt IAS treatment as it is within the US requirements of a 40-year maximum amortisation period. It is possible that with the changes brought about in the UK, FRS 10 may also be accepted as an equivalent standard.

8.4.6. FRANCE.

In France goodwill has a varied treatment with the balance of the acquisition cost not allocated to identifiable assets and liabilities, deemed to be goodwill. There is no maximum amortisation period and normally it is amortised over its useful life. With the many different amortisation periods set out in the PCG it is required that the period used must be stated in the notes. As a consequence actual practice is very diverse. In the majority of cases goodwill is written off over periods of between 10

and 40 years, but on rare exceptional occasions it can be written off against reserves.

Companies like Pernod have written off goodwill arising from various mergers prior to 1987. In 1988 the COB allowed companies to write off goodwill immediately if the acquisition was made through a share issue. It is also worth noting that goodwill could have been created internally in terms of the 1976 legal revaluations.

In a chapter on France by Schneid and Walton (1995, p.189) it is observed that 'the treatment of goodwill is becoming quite uniform.' In a reported survey (1993) of the published accounts of 100 listed companies, 97 companies disclosed that they amortise goodwill. This amortisation took place over varying periods as the following table shows:

Table 8.13 The amortisation period in France

Companies	Amortisation period
3	0-10 years
31	11-20 years
55	21-40 years
8	Not disclosed

The authors were of the opinion that 'there is tendency to write off goodwill over a longer period and also to allocate larger amounts to specific intangible assets such as trade marks, market share and brands and treat these as non depreciable.'

Where there is negative goodwill then a review is done of fair values by writing down assets to eliminate this negative goodwill. This negative goodwill can be shown as a deferred credit and amortised in the profit and loss account.

8.4.7. GERMANY.

German GAAP allows goodwill to be capitalised even though it can not be separated from the business (which is a requirement for an asset). It is regarded more as a technical item than an asset - an 'accounting convenience'.

The 7th Directive allows two methods of treating goodwill, both of which are used in Germany. Under these methods goodwill can either be eliminated against reserves immediately or capitalised and amortised over 4 years or its useful economic life (for which there is no definition). For tax purposes the period is fixed in individual accounts at 15 years and therefore this period for amortisation is the most commonly used when German GAAP is applied (see Table 8.15).

It is argued that the vague nature of goodwill makes an objective estimate of its economic life, impossible. As a result the periods vary enormously and in the data analysis undertaken in this work, Daimler Chrysler, at the one end, adopts a 3-year period and at the other end utilises a 40-year period.

Negative goodwill is shown on the liability side of the balance sheet but HGB §309(2) allows it to be reclassified as a capital reserve or accrued liability. Negative goodwill is shown on the consolidated balance sheet as the 'difference arising on capital consolidation' and may be released to income at a later date only if certain very restricted conditions as set out in HGB §309 (2) are met.

8.4.8. UNITED KINGDOM.

Under SSAP 22 companies were allowed the option of capitalisation and the gradual write off of goodwill against income or an immediate write off against reserves. The permanent retention of goodwill at cost was prohibited and negative goodwill had to be written off immediately. The standard was unique in the way that it showed a preference for the use of the write off method and allowed another. UK companies preferred to write off goodwill directly to reserves and as a result companies who actively acquired other companies found their net assets declining. The debate at the time showed a preference for the weakened balance sheet instead

of the lower earnings per share. They tried to compensate for this by the capitalisation of brands or a revaluation of assets. Consequently accounting for goodwill in group accounts has been a very controversial problem.

SSAP 22 has now been replaced by FRS 10 *Goodwill and Intangible Assets*, (effective from 23 December 1998). The new standard defines purchased goodwill as 'the difference between the cost of an acquired entity and the aggregate of the fair values of an entity's identifiable assets and liabilities.' The definition conforms to that enunciated in IAS 22.

Under FRS 10 there is a requirement to capitalise goodwill as an asset. It also requires that goodwill should be shown separately as should each class of intangible asset.¹²⁸ Where goodwill has a finite useful life then it should be amortised over that useful economic life even though in the past most UK companies wrote off goodwill immediately. FRS 10 is similar to IAS 22 and contains a rebuttable presumption that the useful economic life is limited to 20 years. The period set for its useful economic life varies and in some cases (see, for example, BP and British Aerospace) the period is not specified but is over 'a maximum of 20 years' or 'over its economic life'.

This is confirmed by a survey by Company Reporting (1999) and supported by the analysis contained in this thesis where a high percentage of UK companies do not specify the actual period of the economic life and record that they amortise goodwill over 'the estimated economic life'.

It is possible not to amortise where the economic life is 'infinite', or that amortisation takes place over a period in excess of 20 years. In these events goodwill is subject to impairment reviews as set out in FRS 11 *Impairment of Fixed Assets and Goodwill*. This ensures that goodwill (as well as other fixed assets) is shown at no more than the recoverable amount and that the information is disclosed in the accounts. It also ensures that any impairment loss is measured and

recognised on a consistent basis. Impairment is recognised where the recoverable amount (the higher of net realisable value and value in use, calculated by discounting future cash flows) is below the carrying value. Any impairment losses are shown in the profit and loss account. Company Reporting (September 1999, p.70) points out that the Companies Act requires that fixed assets are subject to systematic depreciation. Where a different accounting treatment is used from that prescribed in order to show a true and fair view, details should be given of the reason and the financial effect. This requirement is repeated in FRS 10.

FRS 10 allows flexibility as to:

- the method of amortisation (straight line or a 'more appropriate method' (para 30);
- the period of amortisation or even if goodwill is to be amortised; and
- the treatment of previously written off goodwill.

In FRS 10 consideration has also been given to goodwill previously written off. The ASB in its 'Foreword to Accounting Standards', stated that new standards should be adopted in such a way that the accounts appear as if the policies in the new standards have always been the policy (para 27-30). Contrary to this, FRS 10 (para 68) says that it is preferable to reinstate goodwill but it is not required to do so as pointed out in Lesson 3 (see 8.4.13).

As with IAS 22 (revised) negative goodwill must be measured and recognised and therefore the excess cannot be used to reduce the fair value of identifiable assets. If negative goodwill should arise the acquirer should first check that the fair values of the separate assets and liabilities have been properly determined. In particular assets should be tested for impairment. The ASB view is that goodwill is not an asset and that negative goodwill is not a liability - both are simply accounting

¹²⁸

In the UK, the Companies Act allows intangible fixed assets, (other than goodwill), to be recorded at their current cost (a departure from the 4th Directive). Although brand names can be valued when they are purchased, or constitute a part of a business, the UK allows a current cost value to be placed on created, or formerly purchased brands.

differences. Both should be presented in the same way - in intangible fixed assets with negative goodwill being deducted from positive goodwill. Any remaining credit balance is released to the profit and loss over the period in which non-monetary assets are depreciated or sold.

To the extent that negative goodwill relates to expectations of identifiable future losses and expenses, which can be measured reliably but are not liabilities at acquisition date, that portion should be deferred and recognised in the profit and loss account when those future losses or expenses occur. Otherwise it is recognised in the profit and loss account over the useful life of the non-monetary assets acquired but only to the extent that negative goodwill does not exceed fair values of non-monetary assets. Any excess is shown as income immediately.

Negative goodwill cannot arise or be increased by the recognition of intangible assets unless they have a readily ascertainable market value.

FRS 11 (effective 23 December 1998) deals with impairment testing for non-financial fixed assets and sets out that impairment is calculated by reference to the net present value of future cash flows.¹²⁹

This is the first UK standard that requires businesses generally to apply discounting in their accounts and deals with tangible assets and investments as well. Selecting the discount rate is crucial and FRS 11 uses the discount rate that the market would expect on an equally risky investment. The range, however, is wide and was shown by Company Reporting, (December 1999, p.4) to be between 7% and 16%. This, in spite of the fact that the relevant discount rates are the long term rates and therefore are not so volatile.

Assets are deemed to be impaired if they no longer are expected to earn a current market rate of return. An upward move in interest rates give rise to a write down in assets even though they generate the same cash flows as before.

¹²⁹ Assets are impaired if they are no longer expected to earn a current market rate of return. Any upward move in interest rates will give rise to a write down in assets even though they may generate the same cash flows as before.

In presentation FRS 10 has had an effect on companies. Where previously they had written off goodwill to a separate goodwill reserve (sometimes leaving a debit balance in reserves), this is no longer acceptable. Although it does not prohibit goodwill reserves, it does not permit companies to include goodwill reserves on the face of the balance sheet. They can just aggregate them with other reserves on the balance sheet (para 71).¹³⁰ There is no guidance but the ASB has indicated that a distributable reserve should be used and not a capital reserve.

If there is a write off to reserves it must be offset against the profit and loss account and not a separate goodwill reserve. Company Reporting (September, 1999, p.4) shows that all companies reporting goodwill capitalised it and 92% of these companies amortised goodwill.

8.4.9. REVIEW OF SAMPLE GROUPS.

In the case of the UK, the introduction of FRS 10 brought about a radical change in accounting disclosure and the groups reviewed adopted the new standard when required. It was not possible to recalculate the annual write off unless each group's accounts were examined for previous years. This would then determine the date of the write off of any goodwill and therefore the current number of years still to be amortised could be calculated.

8.4.10. FRANCE.

In all cases the companies capitalised goodwill and amortised the result over a period ranging from 5 to 40 years. Where maximum periods were stated, then in six groups this was shown as 40 years while in three groups this was shown as 20 years. In two cases (Euro Disney and Gaz de France) no disclosure of goodwill was made either in the notes to the accounts or on the face of the balance sheet. The results here endorse those determined by the FEE survey (see Table 8.10) and the more detailed one in Table 8.11.

¹³⁰ But see Company Reporting (1999, p.3) which states that goodwill must be written off to an 'appropriate reserve'.

Within groups the amortisation period was also variable depending on either the area of activity or the country in which the subsidiary was based. This was seen in CGIP and Legrand. It was considered by CGIP that amortisation over 40 years was appropriate for IT, while car parts were over 20 years and oil products over 10 years.

Another variation on the amortisation period was evident in the accounts of Pernod Ricard where recent acquisitions were subject to a 20 year amortisation while earlier acquisitions had been amortised over 40 years. In a note to the accounts it was stated that about 48% of net goodwill is amortised over 40 years.

Capitalisation did not rule out an immediate write off by some companies in the sample. Under certain conditions CGIP wrote off goodwill, while prior to 1 January 1989, all goodwill was written off by Lafarge. This write off was also practised by Pernod, who wrote off all pre-1987 merger goodwill to equity. This was done according to the law of 3 January 1985 as it related to consolidated accounts.

In an interesting application, Pinault, who capitalise goodwill also took the opportunity of offsetting a goodwill amount of FFr 2664m against the share premium account of FFr 3449m. The reason given by the company was that the group had acquired Guilbert and financed the acquisition by an issue of shares. The notes to the accounts draw attention to the fact that the theoretical amortisation would be FFr 66.6m p.a. over 40 years.

It was noted that many companies including CGIP, Eridania, Lafarge and Pinault stated that any goodwill adjustment required would be made within one year from the date of acquisition. This adjustment was to be based on any differences that may arise within that year.

It is important to observe which groups used French standards and which used US GAAP or IASC standards. While the use of the different standard did not alter the practise of capitalisation, different disclosure criteria were evident. In the case of CGIP and Lafarge, both used IASC standards. Under IAS 22 (revised) there is a 20 year period but in both the above the groups used a 40 year amortisation period. In

the case of Peugeot where US GAAP was used the period of amortisation is stated as 20 years and not one of 40 years, which is allowed by SFAS 121.

The method of amortisation and the many variances encountered both within a group and between groups makes the determination of accounting policy very difficult and complex. When it is considered that goodwill in the reviewed sample groups accounts for up to 80% of equity with an average of some 36%, then it is important that this material asset be fully disclosed and be capable of proper interpretation by a user of the financial statements. It is clear that not even an understanding of the accounting standard used will assist in this task.

8.4.11. GERMANY.

With the exception of Audi who made no disclosure, all groups capitalised goodwill and amortised the resultant amounts over periods varying from between 3 and 40 years. In only one case, Daimler, where US GAAP was used, did the group show a maximum period of amortisation of 40 years. In six cases the maximum period was set at 15 years, while in two cases it was given as 20 years. This seems to be a change from the FEE survey results shown in Table 8.11.

As in the case of France, there were many instances of mixed periods being applied by groups. In the case of Preussag where the 'life' was between 5 and 20 years, a note revealed that the period was based on the strategic value of the acquisition and 'other factors', all of which determined the economic life. BASF also disclosed in a note that acquisitions to 31 December 1997 resulted in the goodwill being written off mainly over 5 years. The amortisation period currently being used by the group is between 7 and 15 years.

In a number of groups evidence was given of a change in accounting practice. In the case of AGIV, capitalisation was new, in that this was only from the 1998 year. In the case of Bayer, goodwill was only shown as an intangible asset from 1 October 1994 and then rateably offset against equity. The capitalisation by Bayer changed the previous practice, which was to offset any goodwill against the consolidated paid in capital. By reversing earlier practice, an amount of DM 280m

was written back from which depreciation of DM 33.7m was deducted although this was not shown in the profit and loss account.

The treatment of negative goodwill varied between the groups although a certain consistency was shown between the treatment and the accounting standard used. Using German GAAP negative goodwill was written off to reserves by AGIV, Hochtief and Preussag. In the case of groups applying US GAAP, the evidence was that negative goodwill was included in income by BASF, while Veba released negative goodwill if there were expected expenses, thereby cancelling the effect of those expenses.

Veba in a note states that this is done under HGB regulations. 'Negative goodwill from the consolidation must be released under HGB of expected expenses that occur at the time the shareholding is acquired and/or upon consolidation for the first time or if it becomes apparent that it corresponds to a released profit on balance sheet date.' Under US GAAP negative goodwill is amortised over the estimated useful life and is released if there are expected expenses.

Most groups used the book value method for goodwill determination, which offsets the acquisition costs against equity and allocates the differences to the subsidiary's assets. Whatever remains is then allocated to either positive or negative goodwill and amortised. In the case of Hochtief and Preussag they allocate hidden reserves first before making the determination of the goodwill. Using US GAAP, Veba noted that the book value method is equal to the purchase method of US GAAP.

As in the case of France, goodwill is a substantial asset of many of the groups within the sample, with it accounting for up to 89% of equity as shown in the case of Preussag.

8.4.12. UK.

With the adoption of FRS 10 there was evidence of capitalisation of goodwill as required. All groups in the sample with year ends after December 1998 had adopted FRS 10 but only one group had adopted it earlier than needed. Pilkington was the

only exception and elected to reinstate goodwill from 1 April 1995. As a result Pilkington also prepared a restated set of accounts to reflect the previous year's comparative figures. In this case the goodwill balance in the balance sheet of £103m incorporates the reinstatement of £108m of goodwill less amortisation of £8m.

The Companies Act requires that goodwill should be depreciated, and any failure to amortise would be a breach of its requirements. In the case of BT, they state that there are circumstances where amortisation of goodwill over a finite period would not give a true and fair view as required by the Companies Act. The group considered that the life of the goodwill is infinite and invoked the true and fair override in order to ensure that goodwill was not amortised. BT makes a limited disclosure that amortisation is not material to the current year's accounts. Where there is no amortisation, then goodwill is subject to an annual impairment review.

In all the other cases reviewed, new goodwill was capitalised and amortised. The period was variously stated as 'useful economic life', 'maximum of 20 years' or '20 years'. While it is assumed that all the groups used the 20 year period for the total goodwill, in the case of Pilkington there were variances of a write off over periods of 2 and 10 years.

An impairment review was disclosed by a number of companies. BOC, for example, showed an amount of £51.8m as impairment of goodwill on a strategic review of the business.

In the case of groups who prepared a reconciliation to US GAAP, it was shown how goodwill affects both equity and profits. In BOC the UK profit is decreased by £7.2m of amortisation but is increased by a goodwill write down of £14.2m and goodwill on disposal of £91.5m. At the same time shareholders funds are increased under US GAAP by a goodwill adjustment of £94.6m.

As was the case in France and Germany, goodwill recorded by the groups in the sample accounts for a high percentage of equity ranging from a high of 75% and with an average of 22%.

The introduction of FRS 10 is an example of an accounting standard in transition and the review of group accounts shows how this new standard is being applied. It is unfortunate that the introduction of FRS 10 has allowed groups to select whether to reinstate goodwill previously written off as well as the period of write off and the method by which it is done.

In spite of this it is now observed that the UK through FRS 10, has brought about a convergence with both France and Germany in its policy of capitalisation. What is not in line is the period of amortisation, which differs not only between countries but also within countries and even within groups.

8.4.13. A REVIEW OF THE RESULTS.

Lesson 1.

The above gives a very strong indication that there are two areas of difference;

- The accounting policy chosen; and
- The estimates made of the economic life of goodwill.

The following table gives a summary of the accounting policy chosen by the groups and shows that there has been a move by the UK during this past year away from the immediate write off of goodwill to that of capitalisation and amortisation.

Table 8.14 Disclosure of the accounting policy used for goodwill on consolidation

	France	Germany	UK
Sample of companies	11	10	10
Evidence of goodwill	9	9	10
Evidence of capitalised goodwill	9	9	9
Evidence of goodwill written off	--	--	1
Alternative/additional method*	3	1	--

* In certain instances some subsidiaries of the group have written off goodwill immediately. This is in addition to the group's normal practice of capitalisation and amortisation.

Where there is a policy change then the estimate of the useful economic life must change and this should be shown in the notes.

Table 8.15 Disclosure of economic life used for amortisation of goodwill

	France	Germany	UK
Sample of companies	11	10	10
Evidence of capitalised goodwill	9	9	9
Amortisation period: 0-10 years	--	--	--
Amortisation period: 11-20 years	4	8	9
Amortisation period: 21-40 years	5	1	--

The above tables clearly demonstrate the movement towards capitalisation and amortisation. It is noticeable, however, that goodwill is amortised over a shorter period in Germany and the UK, while France still opts for the longer period of up to 40 years. In three of the five instances of this longer amortisation period, French GAAP was used, while US GAAP and IAS standards were used in one instance each.

All this must however be read in conjunction with the comments on mixed periods in lesson 2 below.

Lesson 2.

The problem of the amortisation period is one that creates great difficulty for the meaningful understanding of any financial statement. Within any group, the accounting policies relating to the depreciation of individual assets are normally clearly defined and the number of years over which such depreciation is taken is set out in detail. In the case of goodwill, however, there are many instances (an example being CGIP) where the amortisation period of goodwill varies from a low 5 years to a maximum of 40 years. In some groups (for example, Legrand and Veba), they have a range of periods but do not attribute any value to the individual periods over which goodwill is amortised.

This problem of a range of periods is noticeable in both France and Germany. In the UK it seems as though groups are adopting a 20-year period as being the 'economic life' of the capitalised goodwill.

Lesson 3.

Understandably if goodwill is not capitalised retrospectively then the comparability between the periods is sacrificed. This results in two conflicting methods - where 'new' goodwill is capitalised and 'older' goodwill is written off to reserves. As a result the transitional arrangements of FRS 10 dilute substantially its effectiveness. Retrospective capitalisation would have helped if it were made mandatory, as then the accounts would be more consistent. A limitation of SSAP 22 was allowing companies to select from a widely different approach, which led to a lack of consistency and comparability. The limitation of FRS 10 is to allow an option on retrospective capitalisation, which will again cause inconsistency and a lack of comparability.

As the UK moves towards the harmonisation of goodwill, this can be classed as a form of de jure harmony. The adoption of FRS 10 by groups within the UK has

however lead to the disharmony of goodwill disclosure because most of the groups (nine out of ten) did not reinstate goodwill previously written off under the accounting rules of the time.

Lesson 4.

Most researchers are of the opinion that de facto harmonisation is more important than de jure harmonisation. An argument can be advanced that, as can be seen in the UK case, de jure harmonisation gives an earlier warning to users because the rules of accounting measurement and disclosure are announced prior to their being applied. It was noticeable that in the UK there were no groups examined that had elected to adopt FRS 10 earlier than required.

8.5. ACCOUNTING FOR LEASES - AN EVALUATION OF THE CURRENT PRACTICES.

8.5.1. INTRODUCTION.

A lease is a form of finance that provides a significant source of funds for a business, enabling it to purchase all forms of assets. Leasing is said to provide about one-eighth of the world's annual equipment financing requirements.¹³¹

It is of importance to note that the volume of financing of the three countries being examined in relation to the world's largest leasing industry (that of the USA) is as follows:

¹³¹ This was shown in accounting for leases: A new approach, FASB 1996, p.1

Table 8.16 Volume of leasing

Rank	Country	Amount- \$bn
1	United States	140.20
2 (3)	Germany	28.30
3 (4)	United Kingdom	13.45
4 (6)	France	10.93

Source: World Leasing Yearbook 1996, Euromoney Publications.

The problem facing lease accounting is the off-balance sheet effects associated with an operating lease. The fact that any arrangements under an operating lease do not give rise to the recognition of either an asset or a liability increases the return on assets and protects existing debt covenants. It also reduces reported leverage.

This classification has significant reporting consequences and the classification as it presently exists not only affects asset and liability recognition but also the lease expenses in the profit and loss account.

8.5.2. METHODS.

There are two types of lease - finance and operating - and different accounting treatments are recommended for each. The definitions are as follows:

- A finance lease transfers substantially all the risks and rewards of ownership of an asset to the lessee.¹³²
- An operating lease is a lease other than a finance lease. It is similar to a short-term hire of an asset, with no suggestion of transferral of risks and rewards of ownership to the lessee.

¹³²

It should be presumed that such a transfer of risks and rewards occurs if at the inception of the lease the present value of the minimum lease payments, including any initial payments, amounts to substantially all (normally 90% or more) of the fair value of the asset. (para 15). The present value should be calculated by using the interest rate implicit in the lease. If the fair value of the asset is not determinable, an estimate should be used.

Finance leases are capitalised in the lessee's accounts. This means that the leased item should be recorded as an asset in the balance sheet, and the obligation for future payments should be recorded as a liability in the balance sheet.

The capitalisation of finance leases effectively means that all such transactions will affect the lessee's gearing, return on assets and return on investment. Operating leases, on the other hand, are not required to be capitalised. This means that operating leases still act as a form of off-balance sheet financing and are extremely attractive to many lessees.

Lessees may therefore prefer a lease to be called an operating lease. A deal may be structured so that it is treated as an operating lease, for example, if the residual value is significant and not guaranteed by the lessee or a related party (for example, BA). Many leases are prepared in such a way so as to show them as operating leases when the substance appears otherwise.

Resulting from the above, some of the key ratios used in financial analysis become distorted and unreliable in instances where operating leases form a major part of the company's financing.

8.5.3. THE EUROPEAN DIMENSION.

The 4th Directive gives no indication of how leases are dealt with – there is no distinction between a finance and an operating lease. The only possible indication of an application is where Art 2.5 states that if accounts are to reflect assets and liabilities faithfully, then this is a concept close to substance over form.

Table 8.17 Financial lease activity and disclosure

	France	Germany	U K
Sample size	22	49	50
Evidence of activity as a Finance lessee	19	33	39
Disclosed in Fixed Assets or Notes	3	--	39
No disclosure of capitalised lease	16	33	--

Source: 1992 FEE Analysis of European Accounting and Disclosure Practices, p.157.

The table above reflects the fact that in European countries the recognition of economic ownership is not allowed under national laws. As a result assets are only reflected in the balance sheet where a company has legal title to them.

In other countries where economic ownership is allowed, the definition involves a degree of subjective judgement and this results in inconsistent accounting treatment.

Charges under a lease are not required to be disclosed under the 4th Directive or IASC standards. They do however have to be disclosed under SSAP 21. In France disclosure is also required in the consolidated accounts but not in single company accounts.

The following table is extracted from the FEE survey conducted in 1991.

Table 8.18 Lease activity and Profit and Loss disclosure

	France	Germany	U K
Number of companies that charge to profit and loss account	19	33	46
Charge disclosed in profit and loss account	4	--	44
No disclosure of amount charged	15	33	2

Source: 1992 FEE Analysis of European Accounting and Disclosure Practices, p. 161

When the Accounting Advisory Forum prepared a paper entitled 'Accounting for Lease Contracts', they concluded (1995b) that in 'a European context both the method which gives priority to the legal ownership and the method which puts the emphasis on the economic ownership should be allowed as alternative treatments.'

8.5.4. INTERNATIONAL STANDARDS.

IAS 17 was revised in December 1997 and became effective from 1 January 1999. The revision improves the guidance on lease classification and also requires enhanced disclosures. In para 5 it states that 'whether a lease is a finance lease or not depends on the substance of the transaction rather than the form of the contract.'

The definition of a financial lease is one that transfers substantially all risks and rewards to the lessee. The standard requires the lessee to capitalise a finance lease and depreciate it over its useful life, or the lease term, if shorter. The lessee thereby recognises both an asset and a liability equal to the fair value of the asset or the present value of the lease payments if this is less. The discount rate applied is the one used in the lease agreement. Rentals are broken down into two parts, being the repayment of the principal and the interest. The latter is expensed while the principal repayment is set against the liability.

An operating lease is any lease other than a finance lease and all such leases are expensed by the lessee.

Under IAS 17 (revised) disclosures by lessees and lessors have been significantly extended. Lessees must disclose each class of leased asset, minimum lease payments with their present value and a maturity analysis.

8.5.5. US STANDARDS.

The US view is that where substantially all the risks and benefits of ownership are transferred then the lease is a capital lease. Cases where this would apply would be:

- where there is an option to purchase at a bargain price;

- the lease term is equal to or greater than 75% of the estimated economic life of the leased property;
- the present value of rental and other minimum lease payments equals or exceeds 90% of the fair value of the leased property, less any investment tax credit retained by the lessor; or where ownership of the property is transferred at the end of the lease term.

8.5.6. FRANCE.

The Civil Code (Art 1708 et seq) defines a lease as a contract where one party makes available to another, a specific thing over a period in return for a payment. There is no distinction between finance and operating leases and as such the treatment of leases in an individual company account is according to its legal form.¹³³ The asset is recognised by the lessor until a purchase option is exercised and the lessee would not capitalise the lease. This would only be done where the lease agreement includes a purchase clause and the lessee has actually exercised the option. It is nevertheless important that the notes to the accounts are examined as a great deal of information is contained in that section of the accounts.

This treatment can however be altered in the consolidated accounts where a finance lease although not defined in French law, is recognised by the lessee. As such it is capitalised in the consolidated accounts although this is not a legal requirement. In many instances group accounts make use of the definition and disclosures of IAS 17 (revised). There is often no disclosure of the amount of the debt resulting from leasing. The PCG requires the lessor to treat the lease as an asset and so disclose it in its own balance sheet whatever the conditions.

¹³³ There exists a type of finance lease known as *credit bail* (law no.66-455 of 2 July 1966). Under this leasing operation the lessor buys the asset for the sole purpose of leasing. The contract of *credit bail* gives the lessee the option of buying the rented asset for a predetermined price. Nonetheless the lessor remains the owner until that option is exercised.

8.5.7. GERMANY.

Tax rules, not accounting rules, determine the treatment of leases in Germany and as a result the treatment is based on economic ownership. Under tax law this is defined as the right to dispose of property belonging to another and it is this definition of a finance lease that is used. The tax rules for capitalised leases are usually disadvantageous for the lessee and as a result very few companies capitalise financial leases. Where it is done the asset is shown at the present value of the rentals.

To decide if a long-term lease is a financial lease requires a consideration of its tax treatment. A financial lease is defined as a contract that is non-cancellable throughout its initial period during which payments, at least equal to the lessor's acquisition cost and incidental leasing expenses, are made. The amount capitalised by the lessee corresponds to the lessor's cost and includes the lessee's additional own costs. The lessee segregates leasing payments into principal, interest and other expense portions, of which the latter two are, tax deductible.

As a consequence most leases are considered as operating leases and payments are charged to expenses as incurred. Disclosure is made in the notes to the accounts if there is a significant financial commitment.

Accounting for leases by lessors follows the methods stated above. The depreciation charge is that used for tax purposes and it is also used for the calculation of the lease payments. Accrual for potential losses on the disposal of the asset is shown in the commercial accounts but this provision is not allowed for tax purposes.

8.5.8. UNITED KINGDOM.

In the 1980s the use of off-balance sheet finance grew and it became difficult to assess company results because of this. Until 1984 it was believed that lessee companies could hold assets 'off balance sheet' which was a way of allowing companies to hide the true extent of their borrowings. It was defined as 'the

funding or refinancing of a company's operations in such a way that, under legal requirements and existing accounting conventions, some or all of the finance may not be shown on its balance sheet.¹³⁴

Since 1984 lease transactions have been governed by SSAP 21 *Accounting for Leases and Hire Purchase Contracts*. This standard differentiates between a lease and a hire purchase contract. Under a lease, the legal ownership of the asset remains with the lessor throughout the agreement, and possession of the asset returns to the lessor after the lease is completed. In a hire purchase contract, the legal ownership eventually lies with the hirer and possession continues once all the agreed payments have been made.

SSAP 21 distinguishes between finance and operating leases using definitions, which are in line with those of IAS 17.

SSAP 21 requires that assets subject to finance leases should be identified separately and stated in terms of the gross amount and accumulated depreciation. This can be achieved either by separate entries in the fixed asset schedule or by integrating owned and leased assets in this schedule and disclosing the breakdown in the notes to the accounts.

The obligations relating to finance leases can also be treated in two different ways. The leasing obligation should be shown either separately from other liabilities in the balance sheet or integrated into 'creditors due within one year' and 'creditors due after one year' and disclosed separately in the notes to the accounts.

SSAP 21 requires that the total operating lease rentals charged as an expense in the profit and loss account should be disclosed, and these rental should be broken down in respect of hire of plant and machinery and other operating leases. Disclosure is required (para 56) of payments that a lessee is committed to make during the next year, in the second to fifth years inclusive, and over five years.

¹³⁴ Definition by ICAEW, Technical Release 603 (December, 1985, para 5(1)) 'Off-balance sheet Finance and Window dressing.'

The standard proved controversial as it invoked the first formal imposition of a substance over form approach to accounting treatment. This was completely different to the traditional approach, which had strict regard to legal ownership. Its aim was to ensure that legal characteristics of a financial agreement did not obscure its commercial impact. Although it achieved its aim it did not totally eliminate leasing as a vehicle for generating balance sheet finance. This was done by manipulating the '90%' clause and this led ultimately to the introduction of FRS 5, *Reporting the substance of transactions*.

The dissatisfaction is not over the accounting treatment but more so over the classification of leases as financial or operating. Leases can be structured to overcome the 90% test where, if the present value of the minimum lease payments is equal to at least 90% of the fair value of the asset, then it is deemed to be a finance lease.

The treatment of operating leases is contrary to the ASB work. If SSAP 21 was withdrawn and these leases were recognised under FRS 5, then many operating leases would be included on the balance sheet.

It was argued that there were two separate transactions taking place.

1. The company was borrowing funds to be repaid over a period.
2. It was making a payment to the supplier for the use of an asset.

The correct accounting treatment for the borrowing transaction, based on its substance, was to include it as a liability in the lessee's balance sheet. This would represent the obligation to meet the lease payments. The correct accounting treatment for the asset acquisition, based on its substance, was to include the one supplied under the lease as an asset.

Although SSAP 21 does not mention substance over form explicitly, it does state in the foreword that:

It is sometimes argued that leased assets should not be recognised on the company's balance sheet as the company does not have legal title to the asset SSAP 21 recognises that whether an asset is owned, leased or held under a hire purchase contract, it represents an economic source which is needed in the business and which the accounts ought to reflect in a consistent manner.

There was opposition within the accounting profession to the inclusion of a finance lease in the balance sheet as an 'asset'. It was argued that the item, that was the subject of the lease agreement, did not satisfy the existing criterion for classification as an asset because it was not 'owned' by the lessee. To accommodate this, the definition of an asset has been modified from 'ownership' to 'the right to use the item for substantially the whole of its useful economic life.' The legal profession, on the other hand, concentrated on the strict legal interpretation of a transaction. They found that the whole concept of substance over form was contrary to their normal practice.

The main principle underlining FRS 5 is that transactions should be accounted for on the basis of their economic substance rather than their legal form. In relation to leases, FRS 5 states that 'the general principles of FRS 5 will also be relevant in ensuring that leases are classified as finance or operating leases in accordance with their substance.' However, to reduce the conflict between FRS 5 and existing standards, the standard with the more specific provisions should be applied. Consequently SSAP 21 remains the relevant accounting standard for dealing with straightforward leases but FRS 5 is the relevant accounting standard for dealing with more complex leases¹³⁵ or for leases which form part of a series of transactions.

¹³⁵

For example FRS 5 is more specific than SSAP 21 in the case of sale and leaseback arrangements where the original owner sells an asset but continues to use it by leasing it back. The main issue with a sale and leaseback transaction is whether the 'lessee' can de-recognise the asset, show any profit or loss on the sale in the profit and loss account, and treat the lease as an operating lease. The classification will depend on whether substantially all the risks and rewards of asset ownership have, in reality, passed to the buyer.

It defines assets and liabilities. It emphasises controlled economic benefits (assets) and transferable economic benefits (liabilities). Therefore, legal ownership of, or title to assets and legal responsibilities are evaded.

An equity investor, interested in resources available for creating earnings, would prefer that the economic resources be included in the balance sheet under the substance over form principle. This would not apply in the case of a lender who is interested in the assets available as security. It was pointed out in the annual review of the Financial Reporting Council (1999, p.38) that the common and growing practice of analysts 'is to recast financial statements on bases similar to what is proposed' namely to apply the same requirements to all forms of lease.

8.5.9. THE FUTURE.

Current standards relating to leases are in need of revision mainly because they do not require the rights and obligations arising under operating leases to be recognised as assets and liabilities in the financial statements.

It is clear therefore, that the future lies in the overhaul of operating leases. The new approach addresses one of the main problems associated with the current accounting treatment, namely, the potential for framing a finance lease as an operating lease and not having to capitalise the lease contract on the lessee's balance sheet.

'Without a universally accepted theoretical background underlying accounting for leases, the accounting treatments for leases cannot reach any harmonisation.' (Gao, 1994).

The use of off-balance sheet treatment for operating leases detracts from the comparability and usefulness of financial statements and the continuing use threatens their credibility.

The IAS revision must be regarded as a step towards a greater reform. This is now currently being developed by the G4+1 standard setters who have questioned the distinction between finance leases and operating leases and issued a discussion

paper 'Accounting for leases: A new approach', (FASB, 1996). In this paper they recommend that new standards should be developed removing the distinction between finance leases and operating leases. All non-cancellable leases should be capitalised as assets and liabilities by lessees at the present value of their fixed or determinable future lease payments.

As a consequence, leases, where all material rights and obligations meet the accounting framework for the definition of assets and liabilities, would be recognised as such in the lessee's financial statements.

In adopting this approach the use of what was considered as quantitative criteria to judge 'substantially' is replaced. Although it was always intended that the criteria were used as guidance only, in practice the criteria have become the rule. This resulted in specific quantitative tests being 'repackaged' so that a lease would fail in being identified as a finance lease and left off-balance sheet.

In a review of leasing by the G4 +1, they felt that most operating leases could qualify for recognition as assets and liabilities of an enterprise under the applicable conceptual frameworks. They felt (at p.17) that 'a compelling case can be made that any non-cancellable lease will give rise to assets and liabilities that satisfy the recognition criteria.'

Although not agreeing with the G4 + 1 on every point, their view has now been taken up and published by the ASB (1999) in its discussion paper 'Leases: Implementation of a new approach.' Using the approach suggested in the special report of the G4 + 1, the distinction between finance and operating leases would be replaced with a single approach.

8.5.10. REVIEW OF SAMPLE GROUPS.

The two key issues that emerge in accounting for leases are:

1. Does the group have a policy of capitalising finance leases?
2. How is a finance lease defined?

8.5.11. FRANCE.

Of the eleven French companies, eight explicitly disclosed a policy of finance lease capitalisation. Of the others, two, Euro Disney and Pinault Printemps, make it clear that they have what would, according to US GAAP, be regarded as finance leases. This is clear when examining the US GAAP reconciliation where adjustments are made for leases both in expenses and in equity. These leases are subsequently treated as finance leases when adjustments to US GAAP are made by Euro Disney.

Euro Disney discloses that it uses the option contained in French accounting to treat 'finance leases' as operating leases. The group stipulates that the leases are non-cancellable 'operating' leases and gives details of the leases in the notes to the accounts where cost, accumulated depreciation and net book value of these 'operating leases' are shown. They also state that the assumption made is that the group will exercise its purchase option. (Under SFAS 13 a non-cancellable lease, which transfers ownership to the lessee by the end of the lease term, is a finance lease). While not following a capitalisation policy they both give full disclosures of the balance sheet and profit and loss account impact that could arise in the case of capitalisation.

Euro Disney shows finance lease charges as a finance cost rather than as an operating cost. No explanation is offered for this apparent conceptual inconsistency.

In all but one of the sample groups there was no explicit definition given as to what constituted a finance or operating lease. All the companies examined stated that finance leases were capitalised and that they were amortised over the same periods as other fixed assets.

On the definition of a finance lease, two capitalising companies, France Telecom, and Legrand offer explicit definition. The definition can be identified in the following terms: Leased assets are shown as an asset and a liability when the lease terms effectively transfers the risks and rewards of ownership of the asset to the group.

France Telecom gave a very explicit definition of a finance lease while in many other cases such as Euro Disney and Legrand some form of implied definition was conveyed, based on the GAAP used.

Of the remaining other six capitalising companies five imply a definition by stating the GAAP to which they work:

- LVMH and Peugeot follow US GAAP.
- CGIP, Eridania and Lafarge use IASC standards.

In the case of Pernod Ricard this cannot be implied as the group uses French GAAP.

No pattern emerged whereby groups adopting US GAAP or IASC standards could be shown to have given greater disclosure than under French GAAP.

In the main most French companies failed to show the expense of operating leases but dealt with the cost in the notes.

In the case of Gaz de France, the group presents a note (note 3) showing buildings and other tangible assets leased by the group that 'would be recorded' if they were fully owned.

8.5.12. GERMANY.

As leases are still influenced by the tax laws it was not surprising that there was an absence of finance leases. The only time that finance leases were evident was in the case of Bayer and Daimler and in the notes of BASF. In all instances the groups were using either US GAAP or IASC standards.

Operating leases were disclosed in the notes to the accounts and in two cases there was evidence of the write off to profit and loss account. In all other cases although there was some note relating to operating leases, no disclosure was made of the amounts written off to profit and loss account.

The extent of leasing contracts not disclosed was considerable and the individual notes below deal with this.

In examining the German groups, eight of them give no definition at all although, once again, they could be implied, based on the use of US GAAP. In two cases capitalisation is shown in the accounts and in one of these instances, Daimler, there is an explicit definition, while in the other, Bayer, it is implied through the usage of IAS 17. Daimler give a full definition for a capital lease as being where the substantive risks and rewards of ownership have been transferred to the lessee. In addition the group gives a full disclosure of rentals under operating leases which are charged as an expense in the income statement. The note (note 28) also states the future payments under the agreements, all of which are recorded as commitments and contingencies.

In the case of BASF the group states that it uses German GAAP but that accounting policies have been changed wherever possible to bring them in line with US GAAP. Where this is not possible then there is a reconciliation. As such it may be that there are no finance leases, as otherwise they would be allowed for in the reconciliation that the group does as stated in its notes (see page 44 of the annual report). This policy was also followed by Veba and they state the other differences mainly include '...the treatment of lease contracts...' An adjustment in equity and net income, although not specifying 'leases' has been recorded. In addition the group also records under other financial obligations, those for leases.

Degussa also adopt German GAAP and US GAAP insofar as permissible. Unlike BASF they do not show any reconciliation to US GAAP. In a note (note 34) they show financial commitments for leasing agreement payments. This seems to either be a failure to adopt US GAAP (if they are in fact finance leases) or a conceptual failure (by expressing 'operating leases' as 'financial commitments').

It is observed that in three cases, BASF, Degussa and Veba, the groups have used German GAAP but have stated that they have also made use of US GAAP as far as

possible. In two instances reconciliations have been shown between German GAAP and US GAAP.

Surprisingly some groups using US GAAP, namely Degussa and Veba, made no disclosure of finance leases.

8.5.13. UK.

In the UK, SSAP 21 applies and in nine cases there was evidence of capitalisation and amortisation. In eight of these cases there was no explicit definition of what was considered a finance lease while in one case, that of BP Amoco, there was an explicit definition of finance leases. The definition was one that observed such a lease where the group received substantially all the risks and rewards of ownership. The lack of a definition is not surprising as it can be implied by the use of SSAP 21 which gives a broad based definition of a lease and allows the company to interpret it in the way it considers appropriate. This is unlike the situation in the US where the definition, though broad based is strictly enforced.

Other than Allied Domecq, all groups showed that finance leases were capitalised and all, except for BT, where no disclosure was made, showed that these leases were amortised. Operating leases, again with the exception of BT, were all written off to the profit and loss account and the amounts were disclosed of the financial obligations. This disclosure shows a split between operating leases for plant and those for buildings. BT, however, did not make any disclosure but referred to them in the notes. In the case of Allied Domecq, operating lease costs were shown as part of the group's operating costs. No explicit definition of what constituted an operating lease was, however, given.

In the case of BT, the group prepares a reconciliation to US GAAP. In this it is noted that there are no lease cost adjustments either to the net income or to equity. It is therefore assumed that there is no difference in the treatment of leases between the UK and US GAAP.

In the case of BAT and BP Amoco very detailed notes incorporating good disclosures, were given.

Unlike France and Germany there was also evidence in eight cases of operating lease expenses in the profit and loss account. This was as a result of a separate disclosure of costs for these leases in the notes.

8.5.14. A REVIEW OF THE RESULTS.

Lesson 1.

While it is agreed accounting practice that finance leases should be capitalised, the lack of a rigid definition allows groups to circumvent this obligation and continue to show the leasing off balance sheet.

The manner, in which a lease agreement can be rewritten so that it meets the definition of an operating lease, allows for considerable manoeuvrability and a resulting lack of accounting harmonisation.

In virtually all cases no definition was given of what was considered a finance or operating lease. In many cases this was implied by the adoption of US GAAP or IASC standards but it still left the user doubtful as to whether the definition of the standard had been correctly interpreted.

Lesson 2.

The future liability of a group could not be determined because of a lack of disclosure.

No insistence is made for disclosure in the 4th Directive and without, for example, SSAP 21 in the UK, there would be no other need for such. In a similar way this also applies in France and Germany.

The disclosures by French and German groups were inadequate and it was not possible to determine exactly what the groups had done with leases and how they had been treated. It was also impossible to determine the future liability of groups

and the period over which that liability extended. All this made for confusion in attempting an evaluation of the financial statements and comparing one country with another.

Lesson 3.

The lack of a single definition is clearly a problem. It would appear that the only way a user would be able to make such comparison would be if the user had a full knowledge of the national rules in the countries being examined so that it was possible to imply a definition to the treatment of leases. Even so the amounts involved would be difficult to ascertain because of the lack of disclosure. This imprecision of both definition and disclosure makes comparison within a country difficult and between countries even more so. Without a strict and uniform definition and disclosure pattern, harmonisation cannot be achieved.

It is also difficult to see how the extent of harmonisation within a country or between countries can be measured.

8.6. AN EVALUATION OF THE DISCLOSURES MADE ON PENSION AND POST RETIREMENT BENEFITS.

8.6.1. INTRODUCTION.

Accounting for pensions and post retirement benefits is a highly complex topic. The interpretation of the accounting measures used are onerous and difficult and vary not only between country but also within a country as will be seen later in this analysis.

Pension and post retirement benefits are highly influenced by national laws and practices. There are many different forms of pension provisions as can be seen below. These range from the unfunded state schemes operating on a pay-as-you-go basis to the funded schemes controlled by a separate legal entity. All this causes a variety of accounting practices for pension commitments and in analysing these practices a full understanding of national laws is required. Before attempting any

analysis, a brief introduction to the terminology of pensions and post retirement benefits is required.

8.6.2. THE TYPE OF SCHEMES.

There are three basic types of pension scheme. In all instances the employer is liable to contribute towards its cost and the cost of benefits receivable by its employees or their dependants. The three schemes are:

- the state scheme;
- the occupational pension scheme; and
- the personal pension scheme.

The state scheme is a basic earnings related pension operated by a government and is not subject to the control or influence of any group. Most of these schemes are defined contribution plans as the only obligation is for employers and employees to pay the contributions as they fall due. This is often achieved through national insurance payments.

Although there is no legal obligation to pay future benefits, the group may provide post-employment benefits that substitute for State schemes or until a State scheme comes into play (see, for example, France Telecom).

A company may provide post-employment benefits (often defined benefit schemes) which substitute for the state scheme benefits. The company can pay an insurance premium to fund the post employment benefit plan but this does not determine if the plan is a defined contribution or a defined benefit plan. This can be done by looking at the substance of the arrangement. It is a defined benefit plan if the company retains a legal obligation to:

- Pay employee benefits when they fall due; or
- pay contributions if the insurance does not pay all future employee benefits.

In all other cases the insurance plan is a defined contribution plan.

- An occupational pension scheme could provide employees with benefits, which replace, in part, their state benefits.
- Personal pension schemes, which are available to the self-employed or to employees with no company scheme.

Table 8.19 Types of pension plans

	France	Germany	UK
State	All	All	All
Occupational:			
Single employer Schemes	Rare	Majority	Majority
Industry-wide schemes	Minority	Rare	Minority
Private pensions	Rare	Minority	Minority

Source: FEE Survey of Pensions and other Retirement benefits (1995a, p.19).

8.6.3. THE TYPE OF BENEFIT PLANS.

Accounting for pension costs is determined by the type of benefits that are promised by a scheme and by the way in which the employer's obligations in respect of such benefits are funded.

There are two basic types of pension plan:

- the defined contribution plan; and
- the defined benefit plan.

Defined contribution plans (money purchase schemes) where fixed contributions are paid into a separate entity (a fund) present no real accounting problems since the assets in the pension fund determine the amount of the retirement benefits. There is no legal obligation to pay in more in the event of a shortfall. The benefits are determined by the contributions paid and the investment return. The risk, both

actuarial and investment, is with the individual members of the fund. By definition it is a funded plan.

The accounting is very simple. The employee renders services and the company recognises the contributions payable as an expense in exchange for that service. If there are amounts unpaid then they are shown as a liability. If payment is not due within twelve months after year-end then the amount is discounted using the same rate as that for the defined benefit plan. Where a payment is in excess then this is shown as a prepayment.

In a defined benefit plan, (final salary scheme), the benefits to be received in the future are specified. Usually, the benefits are a function of the number of years an employee has been employed and the amount of salary that has been earned during employment. The difficult problem is determining the annual contribution amounts and the pension expense. Factors such as projected future salary levels, employee turnover, employee life expectancy, and pension fund performance affect the calculation. Unlike a defined contribution plan, the actuarial risk (where benefits cost more than expected) and investment risk are borne by the employer and not the employee. The plan can be funded or unfunded and where funded it may be held by an insurance company, investment company or pension fund.

When a defined benefit plan is established, there is immediately a past service cost associated with the plan. A past service cost occurs because employees are given credit for past years of service. Typically, this amount is very large and firms must devise a plan for instalment funding. Since the purpose of adopting a pension plan is to affect future recruitment, retention, and performance of employees, the past service cost is allocated over the current and future periods.

There are various accounting problems not faced by a defined contribution plan. There often are amendments to a pension plan after it is established and actuarial calculations will determine the modification of the pension expense and the fund contributions. Another problem that can arise is that the accumulated pension retirement benefits may exceed the pension fund assets - the obligation may be

underfunded. A provision for the amount of underfunding should be created and any benefits will need to be paid out of the company's own assets when they fall due.

Further accounting complication is brought about because the benefits are subject to a number of major uncertainties and amounts are payable a long time in the future. In the latter instance there is the need to discount that liability.

In funded plans the return on the plan assets affects the cost of providing benefits; the lower the return the higher the cost. The terms of the plan may change and therefore there can be an increase or decrease in the amount of the liability.

Changes in actuarial present value or the value of any plan assets are usually spread over a number of years. Transitional provisions also allow the spreading of some adjustments arising on the adoption of IAS 19 (revised).

8.6.4. FUNDED AND UNFUNDED SCHEMES.

In some countries plans must be funded and in others they are able to choose between a funded and unfunded plan. Many defined benefit plans are funded and some countries require this by law. A company makes a contribution to the fund but retains the ultimate obligation to provide specified levels of retirement benefits. The company must make good any shortfall either by a lump sum payment or through increased contributions.

The company may be entitled to receive any surplus in the fund by means of a refund or reduced contributions in future periods, (see for example, BNFL). The law may restrict the amount or availability of such refunds or reduced contributions.

Funded schemes are where the future liability for benefits is provided for by putting assets in trust. The contributions are invested in a legally separate entity or fund. The fund is administered by third parties, investment company, insurance company or a similar organisation that has the discretion as to the investment of the contributions and the payment of the benefits. Because there is an upper limit of

final salary that is taken into account for pension purposes- the salary cap (there are many different revenue limits), it is possible to have unapproved schemes alongside approved schemes to give unlimited benefits ('top-up pension') for higher paid employees.

In a funded defined benefit plan the liability recognised on the balance sheet is often small and may even be an asset. It reflects the difference between funding and expense recognition and the consequences of accounting for such items as actuarial gains and losses.

Unfunded schemes are where the employer pays the pension benefits and contributions are not made to a separate fund. The benefit is paid out of the company's own assets and it depends on the financial position of the company at the time that payments fall due. No assets are set aside for these liabilities and no provision is made. While this is normal in Germany it is not common in the UK although it is used in the UK for benefits to executives because of the salary cap.

In an unfunded defined benefit plan the amount on the balance sheet is often substantial and may be a major source of financing for the company (for example, Veba).

8.6.5. THE EUROPEAN DIMENSION.

A provision is for liabilities that are almost certain to arise but the amount and timing is uncertain. The problem that arises in creating a provision is to determine the amount that should be set aside. There are a wide variety of practices. Large amounts can be used to reduce current profits while if the provision is too small with a resultant high profit, then dividends may be paid out of those high profits without taking into account future liabilities leading to a reduced company strength.

The 4th Directive (Art 9 and Art 10) requires a disclosure of provisions for pensions and similar obligations and art 43.1.7 requires the notes to set out any pension commitments separately if they are not included in the balance sheet. Therefore it does not require member states to account for commitments but only to disclose

them in the notes. The 4th Directive does not set out any accounting or actuarial methods to be employed to determine these commitments and as shown above, the creation of a provision can be the subject of manipulation.

Understandably therefore, national requirements vary between countries. In France the commercial law requires an estimate be made of all commitments with a disclosure of these estimates in the notes. Germany requires balance sheet disclosure but does not stipulate the accounting method to be adopted. In the UK company law requires that details of the commitments be shown in the balance sheet and SSAP 24 sets out the basis of the disclosure.

In the FEE survey (1992) it was found that a higher number of French companies disclosed pension provisions in their consolidated accounts than in their individual accounts. Also noted were the use of a note disclosure rather than the creation of a provision. The details of disclosures are shown in Table 8.20 below.

Table 8.20 Disclosure of pension provisions

	France	Germany	UK
Sample size	40	49	50
Evidence of pension provisions	13	48	8
Disclose in balance sheet	—	35	—
Disclose in notes	12	12	8

Source: 1992 FEE Analysis of European Accounting and Disclosurc Policies, p. 177.

Where there is a state controlled or legally separate scheme, then there is no provision. This is clearly seen in Table 8.20 as it relates to France and the UK.

In a review of IAS 19 by the Contact Committee,¹³⁶ they concluded that certain accounting solutions are difficult to apply in many EU member states.

¹³⁶

European Commission (1999c).

8.6.6. INTERNATIONAL STANDARDS.

The revised IAS 19 *Employee Benefits*, was approved in January 1998 and is effective from 1 January 1999. It deals with accounting for all types of employee benefits including post-employment benefits and shows how the liability is valued in the case of defined benefit plans.

The standard deals with defined contribution and defined benefit plans. In the case of the former the contributions are expensed as paid out while in the latter case the current service costs are the expenses for the period. The projected unit credit method is used to measure the current cost and the liability (para 64). This method sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

Within the standard, certain topics are covered which are briefly dealt with below.

- The discount rate:

The discount rate is used to determine the present value of the defined benefit obligation and current and past service costs. Reference is made to the market yields at balance sheet date on high quality corporate bonds (para 78). The discount rate reflects the currency and estimated term of the post employment benefit obligations and the estimated timing of benefit payments (para 80). When there is no deep market in high quality corporate bonds, the discount rate is determined by reference to the market yields on government bonds at the balance sheet date (para 78).

The fact that the obligation is measured on a discounted basis means that the company must recognise an interest cost as an expense.

- Gains and losses

Actuarial gains and losses may be offset one against another. IAS 19 (revised) views the estimates of obligations as a range (corridor) around the best estimate and not a precise amount. There is no requirement to recognise gains or losses as income or expenditure or as an adjustment if they are within the 'corridor'.

(This means that the liability is not recognised at balance sheet date and conflicts with 31.1(c)(bb) and 31.1(d), which requires that all foreseeable liabilities must be provided for. Under IAS there is no requirement for a 'corridor' (para 93). Where actuarial gains and losses fall outside the 'corridor' they are amortised over the remaining service life of the employees.

The spread of gains and losses over more than one accounting period gives rise to a potential conflict with the 4th Directive.

Transition adjustments, where an increased liability is determined,¹³⁷ may be spread over a maximum of 5 years or recognised immediately under IAS 8. This allows for an indefinite deferral of a hard core of the actuarial variance. This corridor does allow smoothing but it is argued that there is no merit in this and it will be reviewed. There are separate rules for the recognition of any gains that may arise on adopting IAS 19 (revised).

The IASC have stated that further improvements are to be considered including one where all actuarial gains and losses are recognised immediately in a statement of financial performance. This accords with the current proposal of the ASB as set out in FRED 20.

- Vested or non-vested benefits:
IAS 19 (revised) deals with employee benefits that cover:
 - Salary related benefits e.g. wages, bonus, profit sharing long-service leave,
 - and stock compensation benefits.
 - Post employment benefits e.g. pension, healthcare, and termination benefits.

Vested benefits are not conditional on future employment (Para 7) and the entitlement accrues as service is rendered. Where entitlement cannot be claimed

¹³⁷ This is the difference between the present value of the obligation and the fair value of the plan assets.

until after a minimum period of service, then the benefit is non-vested during that minimum period, for example, the employee is only entitled to benefits after (say) two years employment. The employee's service before the vesting date gives rise to an obligation because the amount of future service that the employee must do before entitlement to the benefit is reduced.

Post-employment benefits are either defined contribution plans or defined benefit plans and may be funded or unfunded. These benefits are payable after completion of employment and include retirement benefits, post employment life insurance and medical care.

IAS 19 sets out details of the disclosure that must be made for defined benefit schemes. This disclosure includes a comprehensive reconciliation of the amounts shown in the balance sheet with the status of the plan and the current value of the obligations. A fair value of plan assets and details of the movements during the period must also be given. Any expense in the profit and loss account must be split between current service cost, interest, actuarial gains and losses, past service cost and the return on plan assets. Another important disclosure is that the principal actuarial assumptions made and used in the accounts are shown.

8.6.7. US STANDARDS.

Funding takes place during the employee's service and plan assets are given up by the company to a separate entity. The objective of funding is to ensure that funds are available to pay any benefits when they become due and this could be described as a financing procedure. A company is able to appoint the trustees for the plan and in that way have some say as to how the assets are invested.

Accounting for the pension costs must be done in such a way that these costs are allocated over the periods of service of employees and this is done in a systematic way. Any pension expense is reduced by any estimated income from plan assets. Where these are past service costs they are amortised.

SFAS 87 requires that in certain instances recognition of certain pension-related events are delayed. This is inconsistent with accrual accounting but is of special importance in pension accounting. Other features are where assets and liabilities are offset and where the net pension cost is shown.

Table 8.21 The six components of pension cost

1. Service cost = present value of benefits.
2. Interest cost.
3. Return on plan assets = fair market value at beginning and end of period. (SFAS 87 requires return to be disclosed)
4. Amortisation of prior service cost- i.e. retroactive benefits.
5. Amortisation of gains and losses. Can defer to future or recognise when occur.
6. Amortisation of unrecognised net obligation or unrecognised net asset at date of initial application of SFAS 87. (Transition amount) Amortise over remaining the service period. If less than 15 years can amortise over a 15 year period.

8.6.8. FRANCE.

Provision for risks and expense is the area that covers pension obligations. It must be noted that there is no separate split between tax and pensions (as required by the 4th Directive) nor is there an analysis between short and long-term elements.

The main source of pension in France is through the social security system (which is compulsory). Under this system all workers are insured for sickness, retirement and family allowances. When an employee retires he qualifies for a one-off lump sum payment from the employer which is based on monthly salary and years served. This is often supplemented by an industry-based scheme.

For the most part, government agencies administer these employee retirement plans. The contributions made by employers are later distributed to ex employees. Essentially, employers operate on a cash basis, with contributions charged to expense as they are made. Under the rules, costs can be deducted when amounts are

paid into an independent pension fund and any amounts provided for the retirement of employees is deductible when actually paid to the employees. No requirements exist for recognising future pension commitments although a provision, which is not tax deductible, can be created.

A few companies provide supplemental benefits and in such cases the companies expense contributions when they are made, although an actuarial method may be used in recording pension liabilities. In calculating these liabilities future payments are discounted at 2% to bring them to present value. All externally funded schemes receive contributions from both the employer and employee in the same way as is done in the UK. It is noticeable that French companies give more details on pensions than their German counterparts. In the main these disclosures show the nature of the pension plan, the results of the valuation and the cost for the period.

The schemes also allow for a growth in salaries. Since the 1960s companies operate pension schemes for all their employees with the costs being spread over the period during which the employer benefits from the employees services.

Where pensions are funded then they are mainly defined contribution schemes although there are also unfunded obligations. Self-invested schemes are very rare in French pension accounting. There are also the top-up schemes (often with insurance companies) which are funded or unfunded. For this the company shows a pension liability and expense although it is not required to do so. The only requirement (COB requirement) is to show a note to the accounts and then this is only in the case of listed companies.

Art 9 (2nd para) of the Commercial law states that commitments on pensions should be estimated and disclosed in the notes. Changes from the traditional cash basis has taken place and undertakings may accrue in part or in full for expenses. The OEC published detailed recommendations of accounting for pensions, requiring that costs be accounted for on an accrual basis. Any change in the plan resulted in an immediate charge to income. This recommendation for the accrual basis found favour with the CNCC.

The CNC ruled that the pay-as-you-go method only applies to commitments to employees who have not yet retired and any commitment to retired employees should be reflected in the accounts. This ruling was endorsed by COB.

It should be noted that there is a minimum period over which an employee must remain in service with the employer in order to be entitled to benefits under a scheme.

8.6.9. GERMANY.

Social security - type programmes are a legal requirement in Germany. Pension funds are funded through insurance companies and employers need only accrue, as a liability, any unpaid premium. All liabilities for pensions must be shown separately.

In Germany there is no stated accounting method for pension fund accounting but the law requires disclosure of costs and commitments in the balance sheet. Further details are given in the notes to the accounts.

The tax requirements in Germany strongly influence pension costs (which are tax deductible) in individual accounts, limiting the amount employers can contribute to an autonomous pension fund. Tax law also places a limit on contributions to *pensionskassen* (captive insurance company) on which tax relief can be claimed.

Section 6(a) of the income tax law deals with pension commitment recognition and provides for accruals for pensions and allows an interest rate of 6%. Where market interest rates are below 6% then the liability is understated. This can be very significant. Provisions may only be set up under certain conditions, one being the vesting of rights, entitling a beneficiary to a once only payment or to recurring pension payments. An employee may work a number of years before pension benefits vest. Normally this vesting takes place when an employee reaches 30 years of age and has been with the employer for at least 10 years.

Under HGB §249(1) an accrual must be set up if the enterprise has contracted a direct commitment resulting in a legal obligation to pay. There are no accruals for

any indirect pension commitments and future pay increases are disregarded. The pension provision is stated at its present value and calculated according to actuarial principles. It must be noted that tax regulations only permit certain actuarial factors to be brought into account in order to compute the present value. The provision is regarded as an uncertain liability. Assumptions are set on a long-term basis, often influenced by tax laws and are infrequently adjusted. The difference between the actuarial calculation in the current year and the previous year is the pension expense for the year.

German companies do not have to transfer contributions to a separate fund and only about 30% in fact do so. Plans are therefore in-house and the assets are shown on the company's balance sheet since there is no segregation. As a result plans are largely unfunded and there are significant liabilities which are shown as accumulated benefit obligations.

Funding pensions through separate pension funds is used by some German companies but as there are tax disadvantages, this is not the preferred method. As a result it is not common to establish a pension fund administered separately from the company affairs. The company shows its accruals for its obligations within its balance sheet and does not fund this accrual by payments to the trustees.¹³⁸ The pension provision is larger than in the UK and this can be cited as an example of the adoption of less conservative accounting in Germany.

A company does not show the pension obligation or market value of assets in its accounts. Where these separate schemes exist no disclosure is made (see for example, Bayer). Where underfunding exists then the deficit amount must be disclosed in the notes as is done by Bayer. In contrast to this Daimler discloses an uninformative note.

In the past when pensions were payable they were taken out of the company account and no provision was made for them. Use was made of the flow through basis and not accruals. Payment of cash was out of the general funds when it

¹³⁸ There is a requirement for mandatory insurance against company insolvency.

became due. Now with the introduction of accruals into German accounting, it has altered. The accrued pension cost covering all rights and claims granted after 31 December 1986 is included in accruals under a separate classification. The former practice still exists for pension obligations incurred prior to 1987 but the amount not provided for must be disclosed in the notes. While some companies such as Bayer have brought into account all pensions obligations and make provision for them, there are still many companies that do not make this disclosure.

Interest is not separately shown on pension assets, as these assets are not segregated from the other assets of the company. It is not possible to determine which assets (if any) are earmarked to pay pension liabilities. Although there is no law to transfer contributions to an independent pension fund, by law the company must allocate actuarially calculated amounts to its pension reserves as and when required. Amounts are therefore shown in a 'pensions reserve' in the balance sheet. About one-third of total funds are invested outside the company via independent pension fund companies. Funds accumulating for the benefit of pensioners are a source of finance for the employing company and the company can invest these funds. Whatever income is earned on the funds is included with the other company income. Therefore the liability for future payments and related assets (i.e. contributions which, in the UK, would be paid to third parties outside the firm) are shown in the company's books rather than the accounts of a pension fund. This provides a substantial liquidity benefit for the company. The method used differs from the UK in that no provision is made for employees under 30 years old and any future pay increases are ignored. The computation, based on current pay levels, underestimates the full liability. The German company meets the liability for the pension and not via a separate fund as in the UK. As such both the assets and liabilities relating to pensions are shown in the company balance sheet.

German companies still set up funds for their non-German operations. The funds are used by the company and it invests them as it likes. They are in fact long-term loans from the employees.

8.6.10. UNITED KINGDOM.

Pension schemes, in the form of a trust, are legally owned by a separate entity from the one that employs the people who benefit. Payments are made by the employer and the employee into this fund (trustee administered) which is operated¹³⁹ to provide benefits. The resultant assets and liabilities are therefore not in the company's accounts. The trust has legal commitments to the employees and any material differences between the assets and liabilities have consequences for the company and must be shown in the accounts.

In the 1980s it was common for the funds to be used for the company. During the 1980s and early 1990s many acquisitions were partly motivated by the desire of acquiring companies to gain access to the cash in the funds as for example in the case of Trafalgar House.

SSAP 24 *Accounting for Pension Costs* issued in 1988, followed the US by matching costs as an expense against the revenue produced while the employees were working for the company. It defines a pension scheme as providing benefits to ex-employees or their dependants. Pension rights are in employee contracts. The benefit is a fraction of the wage/salary received in the last year of employment or over an average of the last (say) three years. The employer must ensure that funds are available to pay the pension on the employee's retirement. Contributions are made by the employer and employee or by the employer alone. The employer needs to recognise the cost on a systematic basis over the period during which there are benefits from the employee's services. Both defined contribution schemes and defined benefit schemes are covered.

When the scheme is under or over funded then there is the need to make an accounting policy decision as to whether to spread the effects over a number of years or take its full impact into the current years' profit and loss.

¹³⁹

The trustees are appointed by the company or jointly by the company and the employees. Payments are invested externally e.g. with an assurance company, or internally through a share in the company assets. Since 1992 they cannot hold more than 5% of the current market value of the scheme in employer-related investments. Often the directors of the main company can control what happens with the resources of the pension fund.

SSAP 24 deals with both the measurement of pension costs and the disclosure of pension information. The main impact of the standard is on defined benefit schemes where employer's obligations are not capable of being defined in an absolute sense. With these schemes the level of contribution for funding are related to current and future pensionable earnings based on actuarial assumptions which have to be determined. When there are changes in the plan such as changes in actuarial methods, etc., the actuary determines over which periods these should be written off.

Actuarial methods are used to determine the size of fund and the contribution patterns required to build up the scheme. While SSAP 24 requires that the actuarial method is used consistently and is disclosed it does not prescribe any particular actuarial valuation method. Where there is any change in method then it must be quantified. The actuary makes assumptions about the return on investment, increases in salary and increases in pension payments. These are only assumptions and there are various uncertain factors e.g. years of service, salary etc. This valuation gives a regular pension cost each year and any variation is recognised over the remaining service lives of the employees. The criticism of SSAP 24 was that there were a number of different valuation methods and ways of accounting for gains and losses. Accounting practice for a defined benefit scheme requires the calculation (by an actuary) of the pension cost. This cost is spread over the service lives of the employees and is increased when there are material deficits or where costs alter due to a change in employee numbers etc. Disclosures made include the type of scheme, if it is funded or unfunded, the accounting policy, how cost is assessed and the date of the last actuarial valuation and any deficit on current funding.

A pension is part of the remuneration of an employee and the problems that exist are of estimation and allocation between accounting periods. Employers recognise the expected costs of a pension provision over the period during which they derive a benefit from the employee's services. The regular cost is recognised every year and variations from this regular cost are allocated over the expected remaining service lives of current employees.

The Companies Act (Sch 4:50) requires full details to be disclosed in the balance sheet. SSAP 24 (para 77) requires that the employer recognise the cost on a systematic basis and charge contributions against profits. In the case of a defined benefit scheme use is made of an actuarial valuation to determine the annual cost. In the UK, the Companies Act requires the following disclosures:

- Any pension commitments included under any provision must be shown in the company's balance sheet.
- Any such commitment for which no provision has been made.

SSAP 24 contains extensive disclosure requirements including the disclosure of any provisions or prepayments in the balance sheet resulting from a difference between the amounts recognised as cost and the amounts funded or paid directly (para 88(f)). In the UK there is a certain degree of pressure on companies to show high profits in the short term. As a result a limit is set for provisions. This is reinforced by the fact that a provision is only made for specifically identified future events.

Provisions are defined as 'any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which it will arise' (Sch 4:89).

It is argued that SSAP 24 has too many options and inadequate disclosure requirements. The latter is surprising, as SSAP 24 has introduced extensive disclosure requirements to enable users to analyse the significance of companies' pension obligations. It must be remembered that prior to SSAP 24 there were limited requirements on disclosure and no guidance on accounting treatment.

There has been considerable lobbying for changes to SSAP 24. In a 1995 discussion paper two approaches were suggested (1) an actuarial approach retaining the principles of SSAP 24 and (2) the market value approach. While there was

noticeably strong support for the first approach, FRED 20 has now been issued as detailed in 8.6.11 below.

8.6.11. THE FUTURE.

With the issue of IAS 19 in February 1998 the ASB has re-examined the approaches and has now issued FRED 20. It seems clear that the way forward especially with an eye on international harmonisation is through the use of market values. In the UK until now reliance had been placed on actuarial valuations and not market value to measure pension funding. There is this move away from actuarial values for assets in a pension scheme. The proposals relating to measurement of costs are identical to IAS 19 and to SFAS 87 but there is a departure from international practice in the recognition of costs. While regular cost is measured on the same basis as IAS 19 and SFAS 87, the variations for actuarial gains and losses are not spread in the profit and loss account over the remaining service lives of the employees. The change in approach introduces volatility into the measurement of the surplus/deficit and while internationally there is a spreading of the gains /losses over service lives it is argued that this means that the balance sheet figure does not present the current surplus or deficit in the scheme. FRED 20 proposes that they be recognised immediately in STRGL and therefore in the balance sheet.

SSAP 24 has been criticised for a number of reasons:

- It gives actuaries a great deal of freedom to decide on the assumptions to be used. Therefore the figures in the accounts are not comparable between companies.
- The standard of disclosure, although requiring a great deal of information, is, in effect poor as it is difficult for the reader to interpret the accounting treatment.
- It is difficult to relate the balance sheet entries to what is actually happening to pension plans.

There is a need to protect the profit and loss account from the volatility of the market value approach and this has been considered in FRED 20. There is an argument that the balance sheet would also be subjected to large and volatile figures. FRED 20 proposes that the surplus/deficit be shown as a separate figure at the bottom of the balance sheet after all other assets. The ASB state that it has legal advice that its proposal would not contravene the law.

FRED 20 moves from the profit and loss account approach to the balance sheet method. When liabilities are calculated using the projected unit method the actuarial assumptions are to be based on current expectations at balance sheet date rather than at the last full valuation date. As obligations are long term in nature they must be discounted. There is a crucial distinction between funding and accounting. The former is about actual investments held while the latter is about best matching assets.

FRED 20 looks like SFAS 87 and IAS 19 except for the way in which the actuarial gains and losses are treated.

The profit and loss charge can be shown as:

- Service cost, plus
- Interest cost, less
- Expected return on assets, plus
- Any special items.¹⁴⁰

The balance sheet prepayment (or provision) will be the plan surplus (or deficit). Gains or losses are shown in the balance sheet but not charged to profit and loss account but to the statement of total recognised gains and losses. This is the key difference between FRED 20, SFAS 87 and IAS 19. In addition the plan assets are

¹⁴⁰ Service cost is the discounted cost of a year's benefit accrual, using the projected unit method and allowing for salary projection. The interest cost is charged on the accrued pension liabilities. The return on assets is the expected return on the assets. Special items include any benefit improvements and gains or losses due to major plan reconstructions.

shown at market value (not the actuarial value of SSAP 24). For determining the liability the market rate of interest is used.

There are a number of objections of which the one is to the showing of pension surpluses and deficits on the balance sheet. It is argued that this brings volatility to the accounts.

In addition to SSAP 24 the Urgent Issues task force have also issued various UITFs. UITF 4, *Presentation of long-term debtors in current assets* deals with a pension surplus. This surplus is to be shown as a prepayment in current assets. Any deficit would normally be shown as a provision in long-term liabilities. This seems to create an anomaly and it is doubtful that the surplus should be a prepayment. The recovery of the asset could be over a number of years and UITF 4 states that where the amounts due after one year are material then they should be shown separately on the face of the balance sheet. SSAP 24 (Para 80) deals with a surplus and says that it should be allocated over the remaining service lives of employees. There are several methods that can be used in the calculation but it is argued if these should be disclosed as the actuarial calculations are, in any case, only estimates. The effect of the surplus is to reduce the charge and/or create a contribution holiday.

UITF 6, *Accounting for post-retirement benefits other than pensions*, extended the accruals accounting principle to cover other types of post retirement benefits, including healthcare. Before its issue, benefits were accounted for on a cash basis but now UITF 6 states that post retirement benefits other than pensions are liabilities and therefore must be shown in the accounts using the accruals and prudence concepts. It also provides that SSAP 24 be applied to their measurement and disclosure.

8.6.12. REVIEW OF SAMPLE GROUPS.

In analysing the accounts for pension accounting practices it is important to recognise the widely different social practices and national laws. This cannot be undertaken without a knowledge of these differences.

In France there are special early retirement schemes provided by the employer. They exist when a company restructures its workforce and is set up and financed by the employer and the state. The problem of the state schemes are that they are unfunded. It is observed that the actuarial surplus or deficit is treated in various ways. This could be either as a refund or a reduction of future premiums.

In Germany no allowance can be made for future salary increases as it is assumed they are close to the current inflation rate. Another aspect of German accounting for pensions is that the projected method must be used to set up book provisions according to German tax law.

In some instances there are insured schemes. Under these the employer transfers some or all of the obligations for pensions by entering into a contract with a life assurance company. They in turn guarantee to meet all or some of the benefits under the scheme. The liability of the life assurance company is limited to the terms of the policy, whereas the liability of the employer to the employee is governed by the terms of the scheme.

It must be pointed out that actuarial valuations were originally developed for funding purposes and not for accounting purposes. In the FEE survey of pensions (1995a, p.72) it is recorded that valuations are methods for 'determining amount of funds required to be set aside annually in order to fulfil future pension commitments under the pension plan which is a separate issue from the measurement of pension costs and pension accruals for accounting purposes.'

8.6.13. FRANCE.

Within the French groups examined there are examples of many different types of pension funding. These range from the reliance on state funded pensions (as in EuroDisney and France Telecom), through to the provision of an insurance funded scheme (an annuity) as is shown in the accounts of CGIP, Gaz de France and Lafarge.

State pension schemes exist where formerly private sector companies were taken into the public sector. It is usual for the company to make a fixed state-determined payment every year. The state guarantees the pensions payments and there is no further liability on the company.

A great deal of emphasis is placed on the vested rights of employees and unless they are in existence no provision for pensions is made. This is evident in the group accounts of Erindania, Pernod and Peugeot.

There is evidence of French companies moving from an unfunded situation to a funded one. What may be considered as funded in the UK sense is not the same in the French concept. Typical of French funding is the case shown in Lafarge where only about 7% of the liability is funded. Other instances are in the case of Pinault where the group states that their scheme is 50% funded and Peugeot where it appears that the scheme is almost fully funded. There is certainly a move towards funding of pension schemes and Legrand is an example of the rapid move towards full funding having gone from an unfunded situation to one where 70% of the liability is currently funded.

Generally the disclosures seen in the group accounts of the French companies varied with groups claiming that they utilised IAS 19 and SFAS 87 in addition to the use of French standards. There was often the failure of compliance with US or IASC standards or a limited compliance. Examples are in the case of CGIP where disclosures do not comply with IAS 19. Erindania is another example of poor disclosure under IAS 19. It is considered by the groups examined that French GAAP is equal to IASC standards and/or US GAAP. Under IAS 19 and SFAS 87 it is stipulated that use be made of the projected unit method.

In other cases no mention was made of pension liabilities as is seen in Euro Disney. Of course this may well be because no additional pensions are provide for by the group.

In France the methodology of accruing is not actuarial. A company will accrue at the end of a period when it thinks a person will reach retirement.

8.6.14. GERMANY.

One of the main reasons given for any increase in pension funding costs was the adoption by German groups of the new mortality tables referred to in the accounts as the Heubeck tables. In some instances these mortality tables were not used. Instead specific tables relating to the chemical industry, PK Chemie, were used. It was noted that in using the latter tables the mortality incidence was lower than in the Heubeck tables. Evidence of this usage is as follows:

- AGIV, who quantified that they needed a DM15.8m higher provision because of the new actuarial tables.
- Hochtief who reported that they had brought in new tables and that as a result the group then added one-quarter of the differential amount to its provision for pensions.
- Preussag who stated that they introduced the new tables after the year-end and the result was an increase in contributions.
- Veba indicated in its accounts that the benefit obligation exceeded the provision because of the new calculations.
- Daimler who records that the new tables resulted in a significant increase in actuarial losses.

Many companies made weak or inadequate disclosures in regard to pension provisions. In some instances the groups made use of US GAAP or IASC standards. In the case of AGIV, the group used German GAAP but also made use of US GAAP by adopting SFAS 87 for the pension disclosures. Although AGIV says that they use SFAS 87 they do not give the required SFAS disclosures. Considerable criticism can be levied against the group accounts of AGIV and the way in which pension fund liabilities are calculated. Veba on the other hand uses SFAS 87 and gives the required disclosure coupled with those of SFAS 132.

The idea of using an international standard can be very helpful because it is more likely that the international investors know it rather than the local practice. Without making the disclosures required by these international standards however the groups only confuse the issue further.

Not all German companies failed to give adequate disclosure. In the case of Daimler there was evidence of very comprehensive disclosures. It may have been that their listing on the NYSE was instrumental in forcing these extra disclosures. Another planned listing on NYSE was illustrated in the case of BASF. They are now complying with US GAAP and as a result had to increase their pension provision by DM1.5 billion in order to comply with the US requirements. The group changed its accounting to US GAAP from 1 January 1998. Good disclosures under SFAS 87 are made including an equity reconciliation to US GAAP at 1 January 1998.

In Germany the income tax law states that companies must use a 6% discount rate. If they use (say) 5% in Europe then the difference of 1% equals (say) a 20% shortage and therefore the liability is higher. A 1% difference in the discount rate can mean a 10% swing in the liability value. Take for example the case where a company has 100m assets and a 100m liability. If the value is a ½% lower discount rate then the liability is equal to 90m. This results in a 10m surplus in assets. Therefore it is important to be clear as to what the disclosures are as regards the discount rate. The use of IAS 19 brings in issues that require companies to provide an increase in liabilities.

The German tax code results in pension liabilities being understated because 6% is higher than the long-term yields. Higher yields result in lower contributions and therefore a lower deduction for tax purposes. Although companies are using something that is lighter than in reality it is nevertheless still comparable. Another example of the difference of a 1% in the discount rate is where the company uses 1% for (say) 20 years before retirement and 1% for (say) 20 years in retirement. All this makes for a big swing that may equal 25% in liabilities.

8.6.15. UK.

While strict compliance to SSAP 24 was noted there were variations by certain groups where additional information was given. This was seen in BOC where they gave details of their funds in various countries. The importance of different environments was stressed in Allied Domecq, Pilkington, GUS, BP Amoco and BOC. In the case of BT it was illustrated by their comparison between UK and US standards. This segmentation of pension plans was very noticeable in UK accounts.

Some companies merely stated that in addition to their UK funds they also have overseas funds and that they are prepared, and the liability calculated, using local conditions. A full understanding of pension liability in countries other than the home country is not possible without having knowledge of local practice and conditions. Other than in the case of BOC the overseas funds were not separately disclosed and the actuarial assumptions were, when given, given within a range of percentages.

One example of the use of a pension fund surplus was given in the accounts of Pennon. In this instance no contributions were made because of the surplus. In other cases such as BOC, funding was suspended for all major funds. British Aerospace amortised its surplus over a 12-14 year period.

In the case of BAT they offset schemes in deficit against schemes in surplus worldwide. As these schemes are in different countries it is difficult to justify how a group can use the surplus of one scheme to offset the deficit of another. This was also evident in BP Amoco where the surplus/deficit was amortised over the working lives of employees. In the case of BNFL this amortisation was only over the lives of the current members and the group then stated that they would thereafter revert to a 12.4% contribution rate.

In one instance, British Aerospace, the group disclosed that the latest valuation for its Royal Ordnance Pension scheme was at 31 December 1995 for December 1998 accounts. The reading of SSAP 24 indicates that valuations should be undertaken at

least once every three years and it is therefore surprising that this was not done in the case of this scheme.

8.6.16. A REVIEW OF THE RESULTS.

In reviewing the results the question is what is the nature of the liability and how is it funded? Is the difference in the scheme or in the method of accounting? Bias comes from different sources but where there is a potential for bias in both instances then there could be said to be harmony.

Lesson 1.

The funding process affects the significance of the items. This raises the question as to whether the consequent accounting difference is a policy choice or a difference in the subject matter.

Lesson 2.

The detail of the disclosure depends on the notional statistical data, which is outside of the control of the accounting profession. For example the use of mortality tables (Heubeck) by German companies.

Lesson 3.

Where the authorities have chosen a basis for the making of an estimate then the policy of fund valuation is the same (for example, 6% interest rate in Germany), but in other cases there is no consistent basis and this results in a different estimate. All this is a difference between the private sector and public sector judgements.

Lesson 4.

There is a growing tendency for French groups to move from an unfunded to a funded situation. This can have very major influences on their financial statements.

CHAPTER 9

SUMMARY AND CONCLUSION.

9.1. INTRODUCTION.

The main purpose of this chapter is to present a summary of the salient aspects of this thesis. Section 9.2 summarises the key issues while 9.3 presents the major findings of the work.

The limitations of the study and suggestions for further research are listed in 9.5 and 9.6 while the 12-point list of problems are covered in 9.7 together with conclusions in 9.8.

This research has addressed the problems raised in the earlier chapters concerning the harmonisation of financial reporting, with special reference to France, Germany and the United Kingdom. In summarising the findings and conclusions the thesis makes a number of recommendations. These are drawn from the lessons learnt from the research as detailed in Chapter 8. By listing twelve problems drawn from those lessons this thesis sets to prove that there is a vital need for qualitative studies and that the understanding of such studies, coupled with the familiarity of the accounting practices in the relevant countries is a pre-requisite for any subsequent quantitative work.

It is important to reiterate that financial reporting is a process whereby a company or group reflects the transactions or events that impact on its assets, liabilities, profit and loss. This is done so as to inform the users of the report. All this data is reflected in the balance sheet, profit and loss account and other financial statements. The manner in which they are reflected are by the use of a measurement policy to disclose transactions and events. The extent of detail of data that is contained in the financial statements is the disclosure policy. These two policies are coupled together to form the accounting policy.

It is this accounting policy, which can and does vary from company to company and group to group. It may be that the cause of this is the many options that are

available within a country or the ever-increasing need for a multinational group to reflect what it considers the best policies. All this decreases comparability for users and so creates an additional burden for investment decisions. For this very reason it is necessary to establish both measurement and disclosure harmonisation.

To do this, standards could be set which would create rules on disclosure and measurement to be used in a financial report. But it is these very standards that are shown to differ from one country to another and where companies are multinational in nature they are left to face possible conflicting standards. This means that standards themselves need to be harmonised and this was previously described as formal harmonisation as opposed to that within reports which was termed material harmonisation.

It is not the province of this thesis to add into its conclusion the way in which harmonisation can be developed. This is left for future research. What is to be highlighted here is the urgency for recognising the fallibility of quantitative research in accounting harmonisation.

Different approaches to research use different methods of collecting data. Quantitative researchers collect facts and study the relationship of one set of facts to another. They measure using scientific techniques to produce quantified and possibly generalised conclusions.

In a qualitative perspective, researchers need to understand an individuals' perceptions of the world. They look to insight rather than statistical analysis. They question whether a scientific approach can be used when dealing with human beings.

Each approach has its strengths and weaknesses and each is particularly suitable for a particular context. This thesis argues that before the quantity can be checked the quality needs definition.

9.2. SUMMARY.

In Chapter 3 it was observed that considerable quantitative research has been undertaken over the past 20 years into the effects of harmonisation and the narrowing of the accounting gap between countries. Linked to this is the extensive research undertaken in creating a classification of national systems of accounting.

This thesis was conceived with an idea of undertaking a critical evaluation of accounting practices in France, Germany and the United Kingdom. It was contemplated that a good deal of input would be obtained from previous classification studies. This would be augmented by an examination of the research into the methodologies used in measurement studies.

It soon became apparent however that the foundation from which it was intended to develop was in itself questionable. This immediately moved the work and the subsequent proposal to one which set out to undertake a qualitative view of a quantitative exercise. It is argued that this line of research is one that has added substantially to the area of knowledge in the field of accounting harmonisation and has made a significant contribution to future academic research.

It is accepted that in making any classification the similarity, as well as any perceived difference of an object, must be established. This allows for the grouping of objects, which ultimately will form a basis for a classification study.

This in turn raises the question of the need to understand the differences and similarities of accounting principles and practices in the individual countries. These principles are different because the economic, social and political environment of each country differs with its resulting impact on accounting. In examining past research it is shown how these differences have led to classification studies by researchers such as DaCosta, Bourgeois and Lawson (1978), Frank (1979), Nair and Frank (1980) and Nobes (1983a).

This thesis also examined and noted how harmonisation studies by Evans and Taylor (1982), McKinnon and Janell (1984), Douppnik and Taylor (1985), Taylor,

Evans and Joy (1986), Nobes (1987), Van der Tas (1988) and Tay and Parker (1990) have developed from research into classifications. With the ever increasing interest in harmonisation, research moved into the area of measuring to ascertain if accounting was becoming more harmonised.

In the field of harmonisation studies, the researchers have as their object the goal of proving that harmonisation has (or has not) taken place. Furthermore they need to determine how this harmonisation can be measured. A challenge is made to the way in which harmonisation measurement has been attempted in the past. Any quantitative exercise lacks the position it claims. It cannot undertake objective measurement.

It is in the field of measurement that a great deal of subjectivity by the researcher is required. This was stated by Nobes (1984, p.32) when he said that 'a classification is by no means theory free. A sensible classification is not produced by a summarisation of a mass of facts. It involves preconceptions, judgements and weightings.' The work by Archer et al (1995) also illustrates this point. In that work (Archer et al, (1995, p.71) they show that in the past companies not reporting on a given item or not disclosing the accounting method used, were excluded from the index. This could result in showing increased comparability, which may not have been there.

The work by Archer et al (1995) proposes a solution for the non-disclosure method and the non-disclosure item. In the first instance there are two alternative situations. The one is that there is insufficient information to determine the method used. The first default is that the company uses the method required by the law of the country. By utilising this default it makes accounts comparable to others in the same country. Alternatively the assumption is not made and therefore the accounts are not comparable as regards the item in question.

Where there is non-disclosure the item may not be reported in the accounts. Goodwill can be used as an example. The researcher can assume that no

acquisitions have taken place and therefore no goodwill arises. As a result the accounts become comparable.

Archer et al proposed a solution whereby a 'disclosure-adjusted' comparability index would be computed which would include the effect of non-disclosure items and the use of default methods.

Roberts (1995) was critical of both the purpose and the methodology used in the classification of accounting systems. He maintained that the relationship between classification and comparison is not clear. He stated (p.643) 'If the process of classification involves the selection of attributes of objects in a particular set which are used to identify resemblance and divergence between those objects and then lead to some objects being classified into one group and others into other groups, then it would appear that the process of comparison has already taken place in the act of classification.'

He questioned the way in which quantitative studies were undertaken. Some attributes are more important than others are and therefore they need some form of weighting. The question then is what criteria are to be used? It cannot be said that statistical techniques in this field add objectivity to any study and Roberts (1995, p. 648) argued that it 'represent(s) an advance on more subjective taxonomies because they are empirical in nature; the classifications can be checked by other researchers using the data and applying the techniques.'

It is also recognised that researchers look at the classification of countries by their accounting environment or systems. Roberts (1995) regards this as a problem because the country could have more than one system such as one applying to public companies and another to private companies. He has in his work recognised the problems by a discussion of the principles involved.

This thesis has set out to show that whilst the quantitative work undertaken has been of immeasurable importance, the qualitative aspect must not be ignored or downgraded. In fact the work shows that it is the qualitative aspect that must be placed at the forefront of any work on harmonisation.

9.3. THE LESSONS LEARNT.

What are the lessons learnt from this work? The lessons as detailed in Chapter 8 need to be grouped so as to determine some form of categorisation. The first group highlights that there is a need to understand the rules. Accounting rules are enforced in each of the three member states in different ways and have all originated for different reasons.

Understanding covers how deferred tax arises in each country; on what basis are different translation methods used; what accounting policy is used in determining the goodwill amortisation period; how are pensions funded and what estimates are made for their determination.

In examining one of the above - the funding of pensions – it is observed that it is related to the age structure of the population. In the countries examined the life expectancy has increased significantly as was illustrated by the use of the Heubeck tables in Germany. As a result comparisons of accounting requirements and practices have certain difficulties.

The nature of the pension arrangements in the various countries contains many different features and these affect the accounting requirements. Specific disclosure requirements in the UK impact on attempts to compare practices in France and Germany. Finally the development of pension arrangements and their place within the culture and traditions of a country means that there is a diversity of issues all of which are considered to be important. Although this is seen in France where occupational pension schemes are not as important and the accounting for pension costs is less of an issue, it is also noted that the tradition is now changing.

Secondly there is a need to understand what the national rules and regulations are before any attempt can be made at classification. Without this understanding and implicitly without the 'local' knowledge, the categorisation and classification is questionable.

Examining national laws in France, Germany and the UK, it is noted that the flexibility of UK rules on deferred taxation is open to abuse and can result in some form of creative accounting. An understanding as to when entities are excluded from consolidation is needed, as this too will affect the disclosure or non-disclosure of deferred tax. In goodwill measurement there is a need to know the rules that are to be applied to the amortisation period together with the rules (if any) in conducting an impairment review. Added to this is the question of how the estimates are made of the economic life of goodwill. More confusingly is the treatment of 'old' goodwill and 'new' goodwill as witnessed in the UK resulting from a change of accounting policy. In accounting for pensions there is the move from funded to unfunded situations and here too it is important to understand the rules. There are many variations on how pension obligations are defined and the extent to which pension liabilities are funded. All this results in different rules and naturally, different commitments and disclosures.

In still a third section it is observed that the groups have followed a particular policy but it is not possible to determine the underlying basis by which the policy was made merely by an examination of the financial statements.

This is well illustrated in the case of leases where a group has not defined a finance or operating lease but rather left it to the user to draw a conclusion and interpretation. The adoption of a policy of amortisation for goodwill, which varies from the type of subsidiary acquired, is a policy frequently adopted by groups but it is not possible to follow or even understand the logic or rationale behind this policy.

Without an answer to the lessons of this thesis and the many more that can be extracted by reviewing other aspects of accounting measurement and disclosure, the quantitative studies previously undertaken, do pose the question of whether measurement by the researchers was from a common base line. Roberts (1995, p.662) in reviewing quantitative studies from a practical viewpoint answers the question by stating that 'classification, because it describes, imposes its own world

view and sets up patterns of thinking, characterisation and influence which may mislead and veil the nature of accounting in different countries.'

From all the above and the research undertaken, it is concluded that these problems also exist in practice. Each country has its own 'idiosyncrasy' and discloses and measures in a different way – even using the same accounting standard.

It is this very point that was raised by the SEC in their 'concept release' (February 2000), which asked a series of probing questions regarding the quality, application and enforcement of IASs. They posed the question as to the way in which IASs would be interpreted and how consistency would be maintained.

9.4. THE FUTURE FOR HARMONISATION.

This work started out when the EC Directives were slowly taking hold in member states. It has seen much change over the years especially the acceptance by France and Germany of international standards for consolidated accounts.

It has now witnessed the endorsement of IASs by IOSCO in Sydney in May 2000. At that meeting IOSCO recommended that members allow multinational issuers to use 30 IASC standards and their interpretations ('the IASC 2000 standards').

The work ends with the final words from the European Commission, which plans formal proposals to enforce the use of international accounting standards by all EU listed companies. Although it is not envisioned that these proposals will take effect much before 2005 it does beg the question - will this lead to acceptance of an international standard? If the answer is in the affirmative then it raises a further question – will this mean a harmonised standard?

At present there is a plethora of accounting standards with vast variations in quality. There are reasons for variations in domestic standards, reflecting as they do the economies, business structures and cultures of the countries themselves. As a result companies in the same industry can give a completely different picture of their performance, merely because of the accounting framework they choose for

their financial statements. Over time standards revert to being more diverse from country to country because government regulators are setting standards.

Already in 1992 the Committee on The Financial Aspects of Corporate Governance issued its draft report and stated (p.21):

A basic weakness in the current system of financial reporting is the possibility of different accounting treatments being applied to essentially the same facts, with the consequence that different results or financial positions could be reported each apparently complying with the overriding requirement to show a true and fair view.

It was recognised at the time that there was a need for financial reporting rules that would limit the scope for uncertainty and manipulation.

In this work it was found that the attempt to classify international accounting by an examination of the financial statements and what is done, is not an issue that readily submits itself to quantitative assessment. There are a whole series of qualitative issues which make it impossible to undertake a meaningful assessment of the diversity in national accounting approaches of the kind that have an objective and measured basis that both accountants and social scientists would like to see.

9.5. LIMITATIONS OF THIS RESEARCH.

Although certain limitations were self-imposed due to financial constraints, there are certain inherent limitations in a work such as this. The use of financial statements does bring into play the need for understanding 'foreign languages' and for ensuring that the 'convenience' translations do convey the identical information of the home based language. It is essential that there should be no large variations in the extent of the disclosure and accounting policies adopted.

The small sample size does present a limitation in a quantitative work but in one of a qualitative nature, the sample has proved adequate in highlighting the 'problems' and in spelling out the lessons to be learnt from this study.

By utilising a single time period it is possible that accounting practices may alter outside of this 'window'. New standards or changes from the home GAAP to an international standard could bring about an easing or even an added complexity to measurement studies. This is seen in the case of the UK standard on goodwill and the adoption by French companies such as Lafarge of IASC standards.

The work showed that the classification produced usually differed from one study to another, depending on the countries, topics used and research methodology applied.

No study can be claimed to be universally accepted as representing a complete and accurate classification of countries based on their accounting practices.

In this research the thesis examined studies that measured harmony levels in accounting practices. They showed varying degrees of international accounting harmony, depending on countries and topics.

Further studies tried to measure the likely impact on profits and assets (Weetman and Gray, 1990 and 1991) and indicated that these differences in reported profits and even asset values could be substantial.

9.6. SCOPE FOR FUTURE RESEARCH.

Based on the limitations of this study there is an area that opens up for further research. This includes the investigation of additional time periods, which may bring into play the application of further accounting standards and practices. The reason for this view is because harmonisation is a dynamic process and changes all the time.

This work made use only of listed companies (groups). There is a further view held that for a deeper insight into measurement and disclosure issues other companies (groups) should also be studied.

The small sample of this thesis can be expanded by a review of additional companies and also countries.

This thesis relied exclusively on the information contained and disclosed in the accounts. Further research using interview techniques, will allow for a greater insight into non-disclosure on any issue and if it is due to non-applicability or to the failure to disclose.

9.7. A REVIEW OF THE PROBLEMS UNCOVERED.

In undertaking the review of the thesis there are a number of issues, which are useful to list. These issues or problems serve to explain the fundamental hypothesis of this work – that quantitative analysis has a very definite limitation and that any attempts at harmonisation studies would be best served by a qualitative analysis in the first instance.

1. There are a number of problems inherent in any quantitative analysis. From this work these problems are identified as being a difference in the accounting policy or in the subject matter being accounted for. Using the results of the sample it can be concluded that this aspect of the research would apply to pensions, goodwill and deferred tax in particular and to a lesser extent to the other topics reviewed.
2. The sample made it clear that it is not possible to identify how estimates are made. This was well illustrated in the lesson of goodwill where there was no clear identification as to the period of amortisation of goodwill. Another area where there was a lack of identification was in the field of foreign currency where the reason behind the selection of the method for translation was never made apparent.
3. When examining the area of pensions another problem arose which would affect any quantitative analysis. It is not possible to assume that pensions both intra and inter country are identically treated. Chapter 8 shows the lessons learnt as they relate to pensions. Lessons 2 and 3 are noteworthy to this problem. In both lessons the accountants do not have control over either the statistical data (life expectancy tables) or, in some cases, the interest rates at which valuations are determined. If this is the case, then how can we in a

quantitative analysis make the assumption that 'pensions' are comparable in accounting terms? This very same problem, of a situation being outside the control of the accountants, also arises in the situation of deferred tax and the planned use by the ASB of a discount rate to offset the full provision charge that is being applied at present.

4. The motive for an accounting policy may define the policy itself. An example of this is in the case of deferred taxation. If a group does not include some deferred tax assets in its accounts, is that because it is taking a partial provision approach as in the UK or because it has adopted a prudent view as in Germany? In an analysis of accounting policy it is not possible to determine if the deferred tax provision is a full provision or not. Deferred tax assets may exist but they are not included in full. The question that begs an answer is - is this full deferral or partial deferral?
5. It is possible to have a transition of a subject matter. This means that the subject matter may have changed in character and therefore it is difficult to tell if the change is in group policy or if, in fact, it is a change in the subject matter. This was well illustrated in the lesson learnt from pension fund accounting where the movement by French companies from an unfunded or partially unfunded situation to a full funding was shown.
6. A common problem that exists is that of a subsidiary which is consolidated into the group accounts where that subsidiary is from a country different to the one of the parent company. In undertaking this consolidation consideration has to be given to the different subject matter which may not look the same as that of the parent company or the 'home' subsidiaries. Examples of this problem can be found in deferred tax where differences between the liability and deferred methods could be trivial unless there is fluctuations in the tax rate from year to year. This highlights just one aspect of the complication of adding subsidiaries from other countries.

7. In many instances the key issue may simply be hidden. This was shown in the lesson learnt from accounting for leases where the lack of a rigid definition for either a finance lease or an operating lease was highlighted. The problem of groups attempting to circumvent the requirement to show finance leasing in their balance sheets even when this was a requirement, such as in the UK, was raised.
8. The significance of an item may vary between countries and this is well illustrated by the example taken from deferred tax. The thesis and sample used showed how the significance of deferred tax to equity varied from 20.49% to 68.58% when the full provision is used instead of a partial provision.
9. There is a relationship between de facto and de jure harmonisation. This can be seen in the UK case with goodwill where, following on the introduction of FRS 10, users were given an earlier warning of the rules for accounting measurement and disclosure. This certainly does not support the view held by many researchers that de facto harmonisation is more important than de jure harmonisation. A further example is in the lack of a single definition in the case of leases. This is further aggravated by a non-consistent disclosure pattern. Without these harmonisation cannot be achieved.
10. A further problem that arises is in the case of transitional accounting policies. With the ever-changing formulation of accounting standards provision must be made for the transition from the 'old' system to the 'new' system. It is this situation that can cause a problem because, although the new policy may create a form of harmonisation, it is not obvious that the past policies have created a position that could be described as distorting. This is adequately documented in lesson 3 of goodwill (see Chapter 8).
11. In many instances there might be a case of simple non-disclosure. If this is so then how can researchers adequately determine the accounting practice of the country? The examples that were highlighted in the non-disclosure of amortisation periods for goodwill, the differences in ways of measurement for

deferred tax by member states and the non-disclosure or inadequate disclosure by French and German groups on their treatment of leases, are good illustrations.

12. A final problem that becomes apparent is one where there is a signalling effect in national accounting policy, which is failed to be teased out in a national or international comparison. This was well illustrated in lesson 4 learnt from the examination of deferred tax. (See Chapter 8).

9.8. CONCLUSION.

Before any quantitative work on measurement can be made to determine the harmonisation gap all the above problems require consideration. If this is not done then on what basis can that work be shown to be one that gives 'a true and fair view' of harmonisation as it is presently taking place? It is argued that these differences are very compelling reasons indeed.

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APPENDIX 1

***EXTRACTS FROM THE ANNUAL REPORT OF BRITISH
TELECOMMUNICATIONS PLC.***

United States Generally Accepted Accounting Principles

The group's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the UK (UK GAAP), which differ in certain significant respects from those applicable in the US (US GAAP).

I Differences between United Kingdom and United States generally accepted accounting principles

The following are the main differences between UK and US GAAP which are relevant to the group's financial statements.

(a) Pension costs

Under UK GAAP, pension costs are accounted for in accordance with UK Statement of Standard Accounting Practice No. 24, costs being charged against profits over employees' working lives. Under US GAAP, pension costs are determined in accordance with the requirements of US Statements of Financial Accounting Standards (SFAS) Nos. 87 and 88. Differences between the UK and US GAAP figures arise from the requirement to use different actuarial methods and assumptions and a different method of amortising surpluses or deficits.

(b) Accounting for redundancies

Under UK GAAP, the cost of providing incremental pension benefits in respect of workforce reductions is taken into account when determining current and future pension costs, unless the most recent actuarial valuation under UK actuarial conventions shows a deficit. In this case, the cost of providing incremental pension benefits is included in redundancy charges in the year in which the employees agree to leave the group.

Under US GAAP, the associated costs of providing incremental pension benefits are charged against profits in the period in which the termination terms are agreed with the employees.

(c) Capitalisation of interest

Under UK GAAP, the group does not capitalise interest in its financial statements. To comply with US GAAP, the estimated amount of interest incurred whilst constructing major capital projects is included in fixed assets, and depreciated over the lives of the related assets. The amount of interest capitalised is determined by reference to the average interest rates on outstanding borrowings. At 31 March 1999 under US GAAP, gross capitalised interest of £499m (1998 - £525m) with regard to the company and its subsidiary companies was subject to depreciation generally over periods of 2 to 25 years.

(d) Goodwill

Under UK GAAP, in respect of acquisitions completed prior to 1 April 1998, the group wrote off goodwill arising from the purchase of subsidiary undertakings, associates and joint ventures on acquisition against retained earnings. The goodwill is reflected in the net income of the period of disposal, as part of the calculation of the gain or loss on divestment. Under US GAAP, such goodwill is held as an intangible asset in the balance sheet and amortised over its useful life and only the unamortised portion is included in the gain or loss recognised at the time of divestment. Gross goodwill under US GAAP at 31 March 1999 of £1,957m (1998 - £925m) was subject to amortisation over periods of 3 to 20 years. Goodwill relating to MCI was unchanged for the period from 31 October 1997 when the investment ceased to have associated company status until disposal on 15 September 1998. The value of goodwill is reviewed annually and the net asset value is written down if a permanent diminution in value has occurred. Under UK GAAP, goodwill arising on acquisitions completed on or after 1 April 1998 is generally accounted for in line with US GAAP.

(e) Mobile cellular telephone licences, software and other intangible assets

Certain intangible fixed assets recognised under US GAAP purchase accounting requirements are subsumed within goodwill under UK GAAP. Under US GAAP these separately identified intangible assets are valued and amortised over their useful lives.

(f) Investments

Under UK GAAP, investments are held on the balance sheet at historical cost. Under US GAAP, trading securities and available-for-sale securities are carried at market value with appropriate valuation adjustments recorded in profit and loss and shareholder's equity, respectively. The net unrealised holding gain on available-for-sale securities for the year ended 31 March 1999 was £76m (1998 - £1,315m relating primarily to the investment in MCI, 1997 - £nil).

(g) Deferred taxation

Under UK GAAP, provision for deferred taxation is generally only made for timing differences which are expected to reverse. Under US GAAP, deferred taxation is provided on a full liability basis on all temporary differences, as defined in SFAS No. 109.

At 31 March 1999, the adjustment of £1,424m (1998 - £2,095m) reconciling ordinary shareholders' equity under UK GAAP to the approximate amount under US GAAP included the tax effect of other US GAAP adjustments. This comprised an adjustment increasing non-current assets by £59m (1998 - £76m decrease); an adjustment increasing current assets by £50m (1998 - £68m increase); £nil adjustment (1998 - £184m decrease) to current liabilities; an adjustment decreasing minority interests by £11m (1998 - £3m decrease) and an adjustment increasing long-term liabilities by £1,544m (1998 - £2,274m increase).

(h) Dividends

Under UK GAAP, dividends are recorded in the year in respect of which they are declared (in the case of interim or any special dividends) or proposed by the board of directors to the shareholders (in the case of final dividends). Under US GAAP, dividends are recorded in the period in which dividends are declared.

II Net income and shareholders' equity reconciliation statements

The following statements summarise the material estimated adjustments, gross of their tax effect, which reconcile net income and shareholders' equity from that reported under UK GAAP to that which would have been reported had US GAAP been applied.

Net income

YEAR ENDED 31 MARCH	1999 £m	1998 £m	1997 £m
Net income applicable to shareholders under UK GAAP	2,983	1,702	2,077
Adjustments for:			
Pension costs	(104)	(66)	83
Redundancy charges	(284)	(253)	156
Capitalisation of interest, net of related depreciation (a)	(19)	(38)	(23)
Goodwill amortisation (a)	85	(71)	(73)
Mobile licences, software and other intangible asset capitalisation and amortisation, net (a)	(226)	42	77
Investments	(6)	5	-
Deferred taxation (a)	220	163	(148)
Other items (a)	(60)	(37)	-
Net income as adjusted for US GAAP	2,589	1,447	2,149
Basic earnings per American Depositary Share as adjusted for US GAAP (b)	£4.02	£2.27	£3.39
Diluted earnings per American Depositary Share as adjusted for US GAAP (b)	£3.93	£2.23	£3.36

Shareholders' equity

AT 31 MARCH

	1999 £m	1998 £m
Shareholders' equity under UK GAAP	14,940	10,785
Adjustments for:		
Pension costs	(1,730)	(1,347)
Redundancy costs	(46)	(41)
Capitalisation of interest, net of related depreciation	245	299
Goodwill, net of accumulated amortisation	293	2,118
Mobile licences, software and other intangible asset capitalisation and amortisation	628	930
Investments	5	1,266
Deferred taxation	(1,424)	(2,095)
Dividend declared after the financial year end	799	736
Other items	(36)	(36)
Shareholders' equity as adjusted for US GAAP	13,674	12,615

(a) The disposal of the group's interest in MCI shares during the year ended 31 March 1999 gave rise to adjustments; increasing net income by £163m relating to goodwill and £95m relating to deferred taxation and decreasing net income by £197m relating to software and other intangible assets, £60m relating to foreign exchange translation differences and £5m relating to the capitalisation of interest.

(b) Each American Depositary Share is equivalent to 10 ordinary shares of 25p each.

III Minority Interests

Under US GAAP, the minority interest charge would have been reduced by £12m (1998 – £5m, 1997 – £nil) after adjusting for goodwill amortisation and accounting for associates and joint ventures. Net assets attributable to minority interests would have been £88m higher (1998 – £81m higher) after adjusting for goodwill, investments and other items.

IV Accounting for share options

Under UK GAAP, the company does not recognise compensation expense for the fair value, at the date of grant, of share options granted under the employee share option schemes. Under US GAAP, the company adopted the disclosure-only option in SFAS No. 123 "Accounting for Stock-Based Compensation" in the year ended 31 March 1997. Accordingly, the company accounts for share options in accordance with APB Opinion No. 25 "Accounting for Stock Issued to Employees", under which no compensation expense is recognised. Had the group expensed compensation cost for options granted in accordance with SFAS No. 123, the group's pro forma net income, basic earnings per share and diluted earnings per share under US GAAP would have been £2,560m (1998 – £1,432m, 1997 – £2,126m), 39.7p (1998 – 22.4p, 1997 – 33.6p) and 38.8p (1998 – 22.1p, 1997 – 33.2p), respectively. The SFAS No. 123 method of accounting does not apply to share options granted before 1 January 1995, and accordingly, the resulting pro forma compensation costs may not be representative of that to be expected in future years. See note 31 for the SFAS No. 123 disclosures of the fair value of options granted under employee schemes at date of grant.

V Consolidated statements of cash flows

Under UK GAAP, the Consolidated Statements of Cash Flows are presented in accordance with UK Financial Reporting Standard No. 1 (FRS 1). The statements prepared under FRS 1 present substantially the same information as that required under SFAS No. 95.

Under SFAS No. 95 cash and cash equivalents include cash and short-term investments with original maturities of three months or less. Under FRS 1 cash comprises cash in hand and at bank and overnight deposits, net of bank overdrafts.

Under FRS 1, cash flows are presented for operating activities; returns on investments and servicing of finance; taxation; capital expenditure and financial investments; acquisitions and disposals; dividends paid to the company's shareholders; management of liquid resources and financing. SFAS No. 95 requires a classification of cash flows as resulting from operating, investing and financing activities.

Cash flows under FRS 1 in respect of interest received, interest paid (net of that capitalised under US GAAP) and taxation would be included within operating activities under SFAS No. 95. Cash flows from purchases, sales and maturities of trading securities, while not separately identified under UK GAAP, would be included within operating activities under US GAAP. Capitalised interest, while not recognised under UK GAAP, would be included in investing activities under US GAAP. Dividends paid would be included within financing activities under US GAAP.

The following statements summarise the statements of cash flows as if they had been presented in accordance with US GAAP, and include the adjustments which reconcile cash and cash equivalents under US GAAP to cash at bank and in hand reported under UK GAAP.

	1999 £m	1998 £m	1997 £m
Net cash provided by operating activities	3,876	3,847	5,066
Net cash used in investing activities	(950)	(4,198)	(2,589)
Net cash used in financing activities	(1,665)	(1,647)	(1,517)
Net increase (decrease) in cash and cash equivalents	1,261	(1,998)	960
Effect of exchange rate changes on cash	33	21	(14)
Cash and cash equivalents under US GAAP at beginning of year	366	2,343	1,397
Cash and cash equivalents under US GAAP at end of year	1,660	366	2,343
Short-term investments with original maturities of less than 3 months	(1,558)	(304)	(2,317)
Cash at bank and in hand under UK GAAP at end of year	102	62	26

VI Current asset investments

Under US GAAP, investments in debt securities would be classified as either trading, available-for-sale or held-to-maturity. Trading investments would be stated at fair values and the unrealised gains and losses would be included in income. Securities classified as available-for-sale would be stated at fair values, with unrealised gains and losses, net of deferred taxes, reported in shareholders' equity. Debt securities classified as held-to-maturity would be stated at amortised cost. The following analyses do not include securities with original maturities of less than three months.

At 31 March 1999, the group held trading investments (as defined by US GAAP) at a carrying amount of £1.678m (1998 – £384m) with fair values totalling £1,678m (1998 – £389m). Held-to-maturity securities at 31 March 1998 and 1999 consisted of the following:

	Amortised cost £m	Estimated fair value £m
UK Government securities and other UK listed investments	25	25
Commercial paper, medium term notes and other investments	18	18
Total at 31 March 1999	43	43
UK Government securities and other UK listed investments	25	25
Commercial paper, medium term notes and other investments	18	18
Total at 31 March 1998	43	43
The contractual maturities of the held-to-maturity debt securities at 31 March 1999 were as follows:	Cost £m	Fair value £m
Maturing on or before 31 March 2000	30	30
Maturing after 31 March 2000	13	13
Total at 31 March 1999	43	43

VII Pension costs

The following position for the main pension scheme is computed in accordance with US GAAP pension accounting rules under SFAS No. 87 and SFAS No. 88, the effect of which is shown in the above reconciliation statements.

The pension cost determined under SFAS No. 87 was calculated by reference to an expected long-term rate of return on scheme assets of 7.7% (1998 – 8.2%, 1997 – 9.2%). The components of the pension cost for the main pension scheme comprised:

	1999 £m	1998 £m	1997 £m
Service cost	387	327	268
Interest cost	1,653	1,554	1,645
Expected return on scheme assets	(1,712)	(1,595)	(1,668)
Amortisation of prior service costs	24	24	24
Amortisation of net obligation at date of limited application of SFAS No. 87	52	52	52
Recognised gains	(137)	(129)	(123)
Additional cost of termination benefits	279	224	258
Pension cost for the year under US GAAP	546	457	456

VII Pension costs (continued)

The information required to be disclosed in accordance with SFAS No. 132 concerning the funded status of the main scheme at 31 March 1998 and 31 March 1999, based on the valuations at 1 January 1998 and 1 January 1999, respectively, is given below.

	1999 £m	1998 £m
Changes in benefit obligation		
Benefit obligation at the beginning of the year	23,513	20,733
Service cost	387	327
Interest cost	1,653	1,554
Employees' contributions	163	157
Additional cost of termination benefits	279	224
Actuarial movement (a)	2,361	1,618
Other changes	25	7
Benefits paid	(1,223)	(1,107)
Benefit obligation at the end of the year	27,158	23,513
Changes in scheme assets		
Fair value of scheme assets at the beginning of the year	22,666	19,879
Actual return on scheme assets	3,050	3,494
Employers' contributions (b)	439	236
Employees' contributions	163	157
Other changes	25	7
Benefits paid	(1,223)	(1,107)
Fair value of scheme assets at the end of the year	25,120	22,666
Funded status under US GAAP		
Projected benefit obligation in excess of scheme assets	(2,038)	(847)
Unrecognised net obligation at date of initial application of SFAS No. 87 (c)	210	262
Unrecognised prior service costs (d)	199	223
Other unrecognised net actuarial gains	(1,039)	(2,199)
Accrued pension cost under US GAAP	(2,668)	(2,561)

(a) The actuarial movements in the years ended 31 March 1998 and 1999 are significant due to the decline in the discount rates used to calculate the benefit obligation as a result of the fall in long-term interest rates in 1997 and 1998.

(b) The employers' contributions for the year ended 31 March 1999 include a special contribution of £200m paid on 31 March 1999.

(c) The unrecognised net obligation at the date of initial application is being amortised over 15 years from 1 April 1988.

(d) Unrecognised prior service costs on scheme benefit improvements, are being amortised over periods of 15 or 16 years commencing in the years of the introduction of the improvements.

The benefit obligation for the main pension scheme was determined using the following assumptions at 1 January 1998 and 1 January 1999:

	1999 per annum %	1998 per annum %
Discount rate	5.5	7.2
Rate of future pay increases	4.8	5.8

The determination also took into account requirements in the scheme as to future pension increases.

Glossary of terms and US equivalents

Term used in UK annual report	US equivalent or definition
Accounts	Financial statements
Advance corporation tax (ACT)	No direct US equivalent. Tax payable on cash dividends treated as advance payments on the company's UK income tax due
Associates	Equity investees
Capital allowances	Tax depreciation
Capital redemption reserve	Other additional capital
Creditors	Accounts payable and accrued liabilities
Creditors: amounts falling due within one year	Current liabilities
Creditors: amounts falling due after more than one year	Long-term liabilities
Debtors: amounts falling due after more than one year	Other non-current assets
Employee share schemes	Employee stock benefit plans
Employment costs	Payroll costs
Finance lease	Capital lease
Financial year	Fiscal year
Fixed asset investments	Non-current investments
Freehold	Ownership with absolute rights in perpetuity
Inland calls	Local and long-distance calls
Interests in associates and joint ventures	Securities of equity investees
Loans to associates and joint ventures	Indebtedness of equity investees not current
Net asset value	Book value
Operating profit	Net operating income
Other debtors	Other current assets
Own work capitalised	Costs of group's employees engaged in the construction of plant and equipment for internal use
Profit	Income
Profit and loss account (statement)	Income statement
Profit and loss account (under 'capital and reserves' in balance sheet)	Retained earnings
Profit for financial year	Net income
Profit on sale of fixed assets	Gain on disposal of non-current assets
Provision for doubtful debts	Allowance for bad and doubtful accounts receivable
Provisions	Long-term liabilities other than debt and specific accounts payable
Recognised gains and losses (statement)	Comprehensive income
Redundancy charges	Early release scheme expenses
Reserves	Shareholders' equity other than paid-up capital
Share premium account	Additional paid-in capital or paid-in surplus (not distributable)
Shareholders' funds	Shareholders' equity
Stocks	Inventories
Tangible fixed assets	Property, plant and equipment
Trade debtors	Accounts receivable (net)
Turnover	Revenues

APPENDIX 2

*THE 4TH DIRECTIVE SET OUT A CHOICE OF FORMATS FOR THE
BALANCE SHEET AND PROFIT AND LOSS ACCOUNT.*

**IN THE ATTACHED PAGES ARE THE FORMATS FOR THE PROFIT
AND LOSS ACCOUNTS AND THE BALANCE SHEETS OF FRANCE,
GERMANY AND THE UNITED KINGDOM.**

Operating income

Sales of merchandise
Sales of own production - goods
 - services
Net sales
Stock variance
Own production capitalised
Operating grants
Write-back of depreciation and provisions, transfers of charges
Other income
Total

Operating expenses

Merchandise - purchases
 - stock variance
Raw materials and supplies - purchases
 - stock variance
Other purchases and external charges
Indirect taxes and similar charges
Wages and salaries
Social security charges
Depreciation and provisions
- oo fixed assets - depreciation
 - provisions
- on current assets
- for risks and future costs
Other expenses
Total

Operating result

Unincorporated joint venture operations
 Profit attributed or loss transferred
 Loss attributed or profit transferred

Financial income

Dividend income
Income from other securities and loans
Other interest and similar income
Write-back of provisions and transfers of charges
Exchange gains
Net gain on sale of marketable securities
Total

Financial expenses

Provisions against financial assets
Interest and related expenses
Exchange losses
Net loss on sale of marketable securities
Total

Net financial result

Ordinary result before tax

Exceptional income

On operating items
On capital items
Write-back of provisions and charges transferred
Total

Exceptional expenses

On operating items
On capital items
Depreciation and provisions
Total

Net exceptional result

Employees' profit share
Corporation tax

Total income
Total expenses

Profit or loss

Formats of the profit and loss account in Germany (literal translation)

Type of expenditure format

1. Sales
2. Increase or decrease in finished goods and work in progress
3. Own work capitalised
4. Other operating income
5. Cost of materials:
 - a) Cost of raw materials, consumables and supplies and of purchased merchandise
 - b) Cost of purchased services
6. Personnel expenses:
 - a) Wages and salaries
 - b) Social security and other pension costs, of which in respect of old age pensions
7. Depreciation:
 - a) On intangible fixed assets and tangible assets as well as on capitalised start-up and business expansion expenses
 - b) On current assets to the extent that it exceeds depreciation which is normal for the company
8. Other operating expenses
9. Income from participations, of which from affiliated enterprises
10. Income from other investments and long term loans classified as financial assets, of which relating to affiliated enterprises
11. Other interest and similar income, of which from affiliated enterprises
12. Amortisation of financial assets and investments classified as current assets
13. Interest and similar expenses, of which to affiliated enterprises
14. Results from ordinary activities
15. Extraordinary income
16. Extraordinary expenses
17. Extraordinary results
18. Taxes on income
19. Other taxes
20. Net income/net loss for the year

Purpose of expenditure format

1. Turnover
2. Cost of sales
3. Gross profit or loss on sales
4. Distribution costs
5. General administrative expenses
6. Other operating income
7. Other operating expenses
8. Income from participations, of which from affiliated enterprises
9. Income from other investments and loans classified as financial assets, of which from affiliated enterprises
10. Other interest and similar income, of which from affiliated enterprises
11. Amortisation of financial assets and investments classified as current assets
12. Interest and similar expenses, of which to affiliated enterprises
13. Results from ordinary activities
14. Extraordinary income
15. Extraordinary expenses
16. Extraordinary results
17. Taxes on income
18. Other taxes
19. Net income/net loss for the year

Formats of the profit and loss account in the United Kingdom

Format 1

1. Turnover
2. Cost of sales
3. Gross profit or loss
4. Distribution costs
5. Administrative expenses
6. Other operating income
7. Income from shares in group undertakings
8. Income from participating interests
9. Income from other fixed asset investments
10. Other interest receivable and similar income
11. Amounts written off investments
12. Interest payable and similar charges
13. Profit or loss on ordinary activities before taxation
14. Tax on profit or loss on ordinary activities
15. Profit or loss on ordinary activities after taxation
16. Minority interests
17. Extraordinary income
18. Extraordinary charges
19. Extraordinary profit or loss
20. Tax on extraordinary profit or loss
21. Minority interests
22. Other taxes not shown under the above items
23. Profit or loss for the financial year

Format 2

1. Turnover
2. Change in stocks of finished goods and in work in progress
3. Own work capitalised
4. Other operating income
5. (a) Raw materials and consumables
(b) Other external charges
6. Staff costs:
(a) Wages and salaries
(b) Social security costs
(c) Other pension costs
7. (a) Depreciation and other amounts written off tangible and intangible fixed assets
(b) Exceptional amounts written off current assets
8. Other operating charges
9. Income from shares in group undertakings
10. Income from participating interests
11. Income from other fixed asset investments
12. Other interest receivable and similar income
13. Amounts written off investments
14. Interest payable and similar charges
15. Profit or loss on ordinary activities before taxation
16. Tax on profit or loss on ordinary activities
17. Profit or loss on ordinary activities after taxation
18. Minority interests
19. Extraordinary income
20. Extraordinary charges
21. Extraordinary profit or loss
22. Tax on extraordinary profit or loss
23. Minority interests
24. Other taxes not shown under the above items
25. Profit or loss for the financial year

Assets

Issued share capital, uncalled

Fixed assets

Intangible fixed assets

Formation costs
Research and development costs
Concessions, patents and similar rights
Goodwill
Other intangible assets
Advances relating to intangibles

Tangible fixed assets

Land
Buildings
Industrial equipment, machinery and tools
Other tangible assets
Fixed assets in progress
Advance payments on fixed assets

Financial fixed assets

Investments under the equity method and in related companies
Amounts receivable from related companies
Other investments
Loans
Other financial fixed assets

Total fixed assets

Current assets

Stocks

Raw materials and supplies
Work in progress - goods
Work in progress - services
Finished goods and by-products
Merchandise

Advances to suppliers

Debtors

Trade debtors and similar accounts
Other debtors
Called up share capital, unpaid

Miscellaneous

Marketable securities
Cash and bank balances

Prepayments

Total current assets and prepayments

Deferred charges
Premiums on redemption of debentures
Unrealised exchange losses

Total assets

Liabilities

Share capital and reserves

Capital
Share premium (mergers, contributions)
Revaluation reserves
Legal reserve
Statutory or contractual reserves
Tax regulated reserves
Other reserves
Profit and loss account brought forward
Result for the period
Investment grants
Special provision for tax purposes
Total

Other funds

Proceeds from issuance of debentures
Advances subject to covenants
Total

Provisions

Provisions for risks
Provisions for charges
Total

Liabilities

Convertible debenture loans
Other debenture loans
Borrowings from credit institutions
Other borrowings and loans
Advances from customers
Trade creditors and similar accounts
Taxes and social security liabilities
Liabilities related to fixed assets and similar items
Other creditors

Deferred income

Total liabilities and deferred income

Unrealised exchange gains

Total liabilities

Format of the balance sheet in Germany (literal translation)

Assets

A. FIXED ASSETS

I. Intangible assets

1. Concessions, industrial and similar rights and assets and licences in such rights and assets
2. Goodwill
3. Payments on account

II. Tangible assets

1. Land, land rights and buildings including buildings on third party land
2. Technical equipment and machines
3. Other equipment, factory and office equipment
4. Payments on account and assets under construction

III. Financial assets

1. Shares in affiliated enterprises
2. Loans to affiliated enterprises
3. Participations
4. Loans to enterprises in which participations are held
5. Long term investments
6. Other loans

B. CURRENT ASSETS

I. Inventories

1. Raw materials and supplies
2. Work in progress
3. Finished goods and merchandise
4. Payments on account

II. Receivables and other assets

1. Trade receivables
2. Receivables from affiliated enterprises
3. Receivables from enterprises in which participations are held
4. Other assets

III. Securities

1. Shares in affiliated enterprises
2. Own shares
3. Other securities

IV. Cheques, cash-in-hand, central bank and postal giro balances, bank balances

C. PREPAID EXPENSES

Equity and liabilities

A. EQUITY

I. Subscribed capital

II. Capital reserves

III. Revenue reserves

1. Legal reserve
2. Reserve for own shares
3. Statutory reserves
4. Other revenue reserves

IV. Retained profits/accumulated losses brought forward

V. Net income/net loss for the year

B. ACCRUALS AND PROVISIONS

1. Provisions for pensions and similar obligations
2. Tax provisions
3. Other accruals and provisions

C. LIABILITIES

I. Loans

of which convertible

2. Liabilities to banks
3. Payments received on account of orders
4. Trade payables
5. Liabilities on bills accepted and drawn
6. Payable to affiliated enterprises
7. Payable to enterprises in which participations are held
8. Other liabilities
of which taxes
of which relating to social security and similar obligations

D. DEFERRED INCOME

Format 1 of the balance sheet in the United Kingdom

A. CALLED UP SHARE CAPITAL NOT PAID

B. FIXED ASSETS

I. Intangible assets

1. Development costs
2. Concessions, patents, licences, trade marks and similar rights and assets
3. Goodwill
4. Payments on account

II. Tangible assets

1. Land and buildings
2. Plant and machinery
3. Fixtures, fittings, tools and equipment
4. Payments on account and assets in course of construction

III. Investments

1. Shares in group undertakings
2. Loans to group undertakings
3. Participating interests
4. Loans to undertakings in which the company has a participating interest
5. Other investments other than loans
6. Other loans
7. Own shares

C. CURRENT ASSETS

I. Stocks

1. Raw materials and consumables
2. Work in progress
3. Finished goods and goods for resale
4. Payments on account

II. Debtors

1. Trade debtors
2. Amounts owed by group undertakings
3. Amounts owed by undertakings in which the company has a participating interest
4. Other debtors
5. Called up share capital not paid
6. Prepayments and accrued income

III. Investments

1. Shares in group undertakings
2. Own shares
3. Other investments

IV. Cash at bank and in hand

D. PREPAYMENTS AND ACCRUED INCOME

E. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

1. Debenture loans
2. Bank loans and overdrafts
3. Payments received on account
4. Trade creditors

5. Bills of exchange payable

6. Amounts owed to group undertakings

7. Amounts owed to undertakings in which the company has a participating interest

8. Other creditors including taxation and social security

9. Accruals and deferred income

F. NET CURRENT ASSETS (LIABILITIES)

G. TOTAL ASSETS LESS CURRENT LIABILITIES

H. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

1. Debenture loans
2. Bank loans and overdrafts
3. Payments received on account
4. Trade creditors
5. Bills of exchange payable
6. Amounts owed to group undertakings
7. Amounts owed to undertakings in which the company has a participating interest
8. Other creditors including taxation and social security
9. Accruals and deferred income

I. PROVISIONS FOR LIABILITIES AND CHARGES

1. Pensions and similar obligations
2. Taxation, including deferred taxation
3. Other provisions

J. ACCRUALS AND DEFERRED INCOME

K. MINORITY INTERESTS

L. CAPITAL AND RESERVES

I. Called up share capital

II. Share premium account

III. Revaluation reserve

IV. Other reserves

1. Capital redemption reserve
2. Reserve for own shares
3. Reserves provided for by the articles of association
4. Other reserves

V. Profit and loss account

APPENDIX 3

STANDARDS IN ISSUE IN UNITED KINGDOM.

- FRS 1 - (Revised 1996) - Cash Flow Statements
- FRS 2 - Accounting for Subsidiary Undertakings
- FRS 3 - Reporting Financial Performance
- FRS 4 - Capital Instruments
- FRS 5 - Reporting the Substance of Transactions
- FRS 6 - Acquisitions and Mergers
- FRS 7 - Fair Values in Acquisition Accounting
- FRS 8 - Related Party Disclosures
- FRS 9 - Associates and Joint Ventures
- FRS 10 - Goodwill and Intangible Assets
- FRS 11 - Impairment of Fixed Assets and Goodwill
- FRS 12 - Provisions, Contingent Liabilities and Contingent Assets
- FRS 13 - Derivatives and other Financial Instruments: Disclosures
- FRS 14 - Earnings per Share
- FRS 15 - Tangible Fixed Assets
- FRS 16 - Current Tax
- FRSSE - Financial Reporting Standard for Smaller Entities
(Effective March 2000)

STATEMENTS OF STANDARD ACCOUNTING PRACTICE (SSAP).

- SSAP 2 - Disclosure of accounting policies
- SSAP 4 - Accounting for government grants
- SSAP 5 - Accounting for value added tax
- SSAP 9 - Stocks and long-term contracts
- SSAP 13 - Accounting for research and development
- SSAP 15 - Accounting for deferred tax
- SSAP 17 - Accounting for post balance sheet events
- SSAP 19 - Accounting for investment properties
- SSAP 20 - Foreign currency translation
- SSAP 21 - Accounting for leases and hire purchase contracts
- SSAP 24 - Accounting for pension costs
- SSAP 25 - Segmental reporting

Note that SSAPs not listed above have been withdrawn.

UITF ABSTRACTS AT 31 MAY 2000

- UITF Abstract 4 Presentation of long-term debtors in current assets
- UITF Abstract 5 Transfers from current assets to fixed assets
- UITF Abstract 6 Accounting for post-retirement benefits other than pensions
- UITF Abstract 7 True and fair view override disclosures
- UITF Abstract 9 Accounting for operations in hyper-inflationary economies
- UITF Abstract 10 Disclosure of directors' share options
- UITF Abstract 11 Capital instruments: issuer call options

- UITF Abstract 12 Lessee accounting for reverse premiums and similar incentives
- UITF Abstract 13 Accounting for ESOP trusts
- UITF Abstract 14 Disclosure of changes in accounting policy
- UITF Abstract 15 Disclosure of substantial acquisitions
- UITF Abstract 17 Employee share schemes
- UITF Abstract 18 Pensions costs following the 1997 tax changes in respect of dividend income
- UITF Abstract 19 Tax on gains and losses on foreign currency borrowings that hedge an investment in a foreign enterprise
- UITF Abstract 20 Year 2000 issues: accounting and disclosures
- UITF Abstract 21 Accounting issues arising from the proposed introduction of the euro
- UITF Abstract 22 The acquisition of a Lloyd's business
- UITF Abstract 23 Application of the transitiona rules in FRS 15
- Note that UITF Abstracts not listed above have been superseded by a FRS.

APPENDIX 4

LIST OF INTERNATIONAL ACCOUNTING STANDARDS.

- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 7 Cash Flow Statements
- IAS 8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies
- IAS 10 Events After the Balance Sheet Date
- IAS 11 Construction Contracts
- IAS 12 Income Taxes
- IAS 14 Segment Reporting
- IAS 15 Information Reflecting the Effects of Changing Prices
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 19 Employee Benefits
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21 The Effects of Changes in Foreign Exchange Rates
- IAS 22 Business Combinations
- IAS 23 Borrowing Costs
- IAS 24 Related Party Disclosures

- IAS 25 Accounting for Investments
- IAS 26 Accounting and Reporting by Retirement Benefit Plans
- IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries
- IAS 28 Accounting for Investments in Associates
- IAS 29 Financial Reporting in Hyperinflationary Economies
- IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions
- IAS 31 Financial Reporting of Interests In Joint Ventures
- IAS 32 Financial Instruments: Disclosures and Presentation
- IAS 33 Earnings Per Share
- IAS 34 Interim Financial Reporting
- IAS 35 Discontinuing Operations (1.1.99)
- IAS 36 Impairment of Assets (1.7.99)
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets
- IAS 39 Financial Instruments: Recognition and Measurement
- IAS 40 Investment Property

APPENDIX 5

FOURTH COUNCIL DIRECTIVE

SECTIONS AND ARTICLES OF DIRECTIVE 78/660/EEC OF 25 JULY 1978

Sect 1	General Provisions	Art2
Sect 2	General provisions concerning the balance sheet and profit and loss account	Art 3-7
Sect 3	Layout of the balance sheet	Art 8-14
Sect 4	Special provisions relating to certain balance sheet items	Art 15-21
Sect 5	Layout of the profit and loss account	Art 22-27
Sect 6	Special provisions relating to certain items in the profit and loss account	Art 28-30
Sect 7	Valuation rules	Art 31-42
Sect 8	Contents of the notes on the Accounts	Art 43-45
Sect 9	Contents of the annual report	Art 46
Sect 10	Publication	Art 47-50
Sect 11	Auditing	Art 51
Sect 12	Final provisions	Art 52-62

APPENDIX 6

SEVENTH COUNCIL DIRECTIVE

SECTIONS AND ARTICLES OF DIRECTIVE 83/349/EEC OF 13 JUNE 1983

Section 1	Conditions for the preparation of consolidated accounts.	Art 1-15
Section 2	The preparation of consolidated accounts.	Art 16-35
Section 3	The consolidated annual report.	Art 36
Section 4	The Auditing of consolidated accounts.	Art 37
Section 5	The Publication of consolidated accounts.	Art 38
Section 6	Transitional and final provisions.	Art 39-51.

APPENDIX 7

LIST OF GROUPS USED IN SAMPLE WITH ABBREVIATIONS USED.

France

Compagnie Generale d'Industrie et de Participations SA	CGIP
Erindania Beghin-Say SA	Erindania Beghin-Say
Euro Disney SCA	Euro Disney
France Telecom SA	France Telecom
Gaz de France SA	Gaz de France
Lefarge SA	Lefarge
Legrand SA	Legrand
LVMH Moet-Hennessy Louis Vuitton SA	LVMH
Pernod Ricard SA	Pernod Ricard
Peugeot SA	PSA Peugeot
Pinault-Printemps-Redoute SA	Pinault-Printemps

Germany

AGIV AG	AGIV
Audi AG	Audi
BASF AG	BASF
Bayer AG	Bayer
DaimlerChrysler AG	DaimlerChrysler

Degussa AG

Degussa

Deutsche Babcock AG

Deutsche Babcock

Hochtief AG

Hochtief

Preussag AG

Preussag

VEBA AG

Veba

United Kingdom

Allied Domecq PLC

Allied Domecq

British American Tobacco plc

BAT

British Nuclear Fuels plc

BNFL

The BOC Group PLC

BOC

BP Amoco plc

BP Amoco

British Aerospace PLC

British Aerospace

British Telecommunications plc

BT

The Great Universal Stores PLC

GUS

Pennon Group plc

Pennon

Pilkington PLC

Pilkington

APPENDIX 8

GLOSSARY OF ACRONYMS.

AktG	Aktiengesetz	Stock Corporation Act
ACCA	Association of Chartered Certified Accountants	
APB	Auditing Practices Board	
ASB	Accounting Standards Board	
ASC	Accounting Standards Committee	
BiLiRig	Bilanzrichtliniengesetz	Accounting Directives Act
CGI	Code Général des Impôts	General tax code
CNC	Conseil National de la Comptabilité	National Accounting Council
CNCC	Compagnie Nationale des Commissaires aux Comptes	National Institute of Statutory Auditors
CNP	Comité des Normes Professionnelles	Professional Standards Committee
COB	Commission des Opérateurs de Bourse	National Securities Commission
CRC	Comité de la Réglementation Comptable	Accounting Regulatory Committee
CU	Comité d'Urgence	Urgent issues committee

DGI	Direction Général des Impots	Tax administration
DRSC	Deutsche Rechnungslegungs Standards Committee	
EstG	Einkommensteuergesetz	Income Tax Act
ED	Exposure Draft	
FEE	Federation des Experts Comptables européens	Federation of European Accountants
FRC	Financial Reporting Council	
FRED	Financial Reporting Exposure Draft	
FRS	Financial Reporting Standard	
FASB	Financial Accounting Standards Board	
GAAP	Generally accepted accounting principles	
GoB	Grundsätze ordnungsmässiger Buchführung	Principles of proper bookkeeping
HGB	Handelsgesetzbuch	Commercial Code
IAS	International Accounting Standard	
IASC	International Accounting Standards Committee	

IOSCO	International Organisation of Securities Commissions	
IdW	Institut der Wirtschaftsprüfer	German Institute of Certified Public Accountants
KapAEG	Kapitalaufnahmeerleichterungsgesetz	The law for improved equity raising capabilities
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich	Law for control and transparency in companies
OECD	Organisation for Economic co-operation and Development	
OEC	Ordre des Experts Comptables	National Institute of Public Accountants
PCG	Plan Comptable Général	General Accounting Plan
PublG	Publizitätsgesetz	Disclosure Act
SEC	Securities and Exchange Commission	
SFAS	Statement of Financial Accounting Standards	
SORP	Statement of Recommended Practice	
UITF	Urgent Issues Task Force	
WP	Wirtschaftsprüfer	Certified auditor

APPENDIX 9

*THE FOLLOWING PAGES DETAIL THE RESULTS OF THE
EXAMINATION OF ACCOUNTING MEASUREMENT AND DISCLOSURE
PRACTICES BY THE GROUPS IN FRANCE, GERMANY AND THE
UNITED KINGDOM.*

France - Deferred taxation practices

Company Name	Method of calculating provision Liability	Extent of provision		If full prov.	Equity FFr. m	% to equity	Full %	% of def tax to total prov for liab.	Disclosed def tax liab- FFr.m	Disclosed def tax asset- FFr.m	Prov for liabilities
		Full	Partial								
CGIP	*	*			13508	1.46	0	4.08	196.64	98.44	4821.86
Eridania Beghin-Say	*	*		1315	22593	1.53	5.82	1.13	345		30480
Euro Disney	*	*			7328	0	0	0.00	0		8420
France Telecom	*	*			111456	0.79	0	0.47	875	19193	166212
Gaz de France	*	*		?	17633	0	#VALUE!	0.00	0	0	51295
Lafarge	*	*		4699	29521	0.42	15.92	0.29	124		42178
Legrand	*	*			7297	3.21	0	1.81	234	242	12917
LVMH	*	*			41431	2.91	0	2.01	1204	1342	59775
Pernod Ricard	*	*			11992	3.23	0	2.87	387	312	13468
Pinault Printemps	*	*			20241	2.08	0	0.72	421	396	58403
PSA Peugeot	*	*			55768	17.72	0	5.96	9881	3763	165725
Average								1.76			

Germany - Deferred taxation practices

Company Name	Method of calculating provision		Extent of provision		if full prov.	Equity DMm	% to equity	Prov for losses c/twd	% of def tax to total prov for liab.	Disclosed def tax liab- DM	Disclosed def tax asset- DM	Prov for liabilities
	Liability	No Disclosure	Full	Partial								
AGIV	NONE						#DIV/0!		#DIV/0!			
Audi		*					#DIV/0!		#DIV/0!			
BASF	*			*		25288.2	#VALUE!		#VALUE!	?	2107	?
Bayer	*		*			24991.0	6.14	yes	4.76	1534	754	32225
Daimler Chrysler	*		*			30367.0	13.72	yes	4.11	4165	5016	101321
Degussa	*			*		2640.4	2.21		0.79	58.4	65.3	7424.6
Deutsche Babcock	*					200.9	#VALUE!		#VALUE!	?		4143.08
Hochtief	NONE					2588.6	1.13		0.52	29.20		5579.52
Preussag	*		*			2897.7	21.69		4.64	628.43		13545.11
Veba	*		?			26342.0	10.33	no	7.15	2722		38059
Average									#VALUE!			

United Kingdom - Deferred taxation practices

Company Name	Method of calculating provision		If full prov.	Equity £m	% to equity	Full %	Prov for overseas entities	Prov for losses c/fwd	Prov on disposals properties	% of def tax to total prov for liab.	Disclosed def tax liab- £	Disclosed def tax asset- £	Prov for liabilities
	Liability	Partial											
Allied Domecq	*	*	91	2273	1.54	4.00	no		no	20.23	35		173
BAT	*	*	307	64	73.44	479.69	no		no	6.34	47	225	741
BNFL	*	*	759	640	118.59	118.59				4.67	759		16253
BOC	*	*	214.7	1840.5	1.14	11.67	no	no		6.06	20.9		345
BP Amoco	*	*	6309	41786	3.91	15.10	no			15.62	1632		10449
British Aerospace	*	*	75	2020	1.88	3.71	no		no	3.48	38	118	1092
BT	*	*	2245	14940	2.34	15.03				25.16	350		1391
GUS	*	*	85.5	2409.1	1.92	3.55			no	37.43	46.3		123.7
Pilkington	*	*	110	742	0.13	14.82	no	no		0.19	1	54	516
Pennon	*	*	175.3	891.7	0.00	19.66				0.00	0	0	26.5
Average					20.49	68.58				11.92			

France - Analysis of foreign currency

Company Name	Acc Std	Balance Sheet		Profit & Loss	High Inflation area subsidiaries	
		Closing rate	W/off to reserves	Average rate	Inflation adj	Temporal
CGIP	F	*	*	*		
Eridania Beghin-Say	IAS	*	*	*	*	
Euro Disney	F	*	*	*		
France Telecom	F	*	*	*		*
Gaz de France	F	*	*	*		
Lafarge	IAS	*	*	*	*	
Legrand	US	*	*	*	*	
LVMH	US	*	*	*		
Pernod Ricard	F	*	*	*		
Pinault Printemps	F	*	*	*		
PSA Peugeot	US	*	*	*		

Germany - Analysis of foreign currency

Company Name	Acc. Std.	Balance Sheet			Profit & Loss		High Inflation area subsidiaries	
		Closing rate	Temporal	W/off to reserves	Average rate	W/off to P&L	Inflation adj	Temporal
AGIV	G	*		*	*			
Audi	G	NONE		*				
BASF	G & US	*	*	*	*			
Bayer	IAS	*	*	*	*		*	*
Daimler Chrysler	US	*		*	*			*
Degussa	G=US	*	*		*			
Deutsche Babcock	G	*		*	Not disclosed		*	
Hochtief	G	*		*				
Preussag	G	*		*	*	*	*	
Veba	G & US	*		*	*			

United Kingdom - Analysis of foreign currency

Company Name	Balance Sheet		Profit & Loss			High Inflation area subsidiaries	
	Closing rate	W/off to reserves	Average rate	Closing rate	W/off to P&L	Inflation adj	Temporal
Allied Domecq	*	*	*				
BAT	*	*	*		*		*
BNFL	*	*		*	*		
BOC	*	*	*		*		
BP Amoco	*	*	*				
British Aerospace	*	*	*				
BT	*	*	*		*		
GUS	*	*	*		*		
Pilkington	*	*	*		*		
Pennon	*	*	*		*		

France - Analysis of goodwill

Company Name	Accounting Standard	Immediate write off	Capitalise	Amortise	Period of amortisation	Notes	Method of Computing
CGIP	French?? IAS	.	.	.	40 yrs - IT; 20 yrs - car parts & 10 yrs oil prod.		Share net assets after allocating to identifiable assets. Write down if under 20m etc
Eridania Beghin-Say	IASC but not use IAS 22		.	.	40 yrs. Specific cases 20 & 15 yrs. 35% over shorter periods of 20 yrs and 15 yrs	Not use IAS 22. If had then gwl 970m higher and write off over 20 yrs 153m higher	Pur price and restated net worth of coy. Done within 1 yr.
Euro Disney	French					No disclosure	
France Telecom	French		.	.	5-20 yrs straight line		&
Gaz de France	French		NONE			No disclosure	
Lafarge	IASC	.	.	.	40 yrs	Allow 1 yr before finalising allocation	&
Legrand	US GAAP		.	.	Main (738/2122) = 34.8% over 40 yrs. Other 5-20 straight line		&
LVMH	US GAAP		.	.	5-40 yrs straight line		&
Pernod Ricard	French		.	.	20-40 yrs Recent is 20 yrs straight line	Write off gwl prior 1987 to equity	
Pinault Printemps	French		.	.	40 yrs straight line	Allocation subs during year pending at year end	&
PSA Peugeot	French??US	Where minority interest then in P&L	.	.	20 yrs straight line		&

France - Analysis of goodwill

Company Name	How write up	Impairment review	Net B/s amount	P&L amount	Turnover	Equity	% of equity	P&L charge as % turnover
CGIP			2419.4	107.2	1893.3	13508	17.9	5.7
Endania Beghin-Say	If exceed price then gwl limited to initial diff.		5300	246	64866	20541	25.8	0.4
Euro Disney			0	0	5895	7328	0.0	0.0
France Telecom		Compare carrying value to undiscounted cash flow	5720	556	161678	111456	5.1	0.3
Gaz de France			0	0	58706	17633	0.0	0.0
Lafarge		Use IAS 22 (new) but allow longer periods than 20 yrs subject to annual review	17510	700	64294	28521	59.3	1.1
Legrand		Evaluate future cash flows	2122	117	14278	7297	29.1	0.8
LVMH		Write down if cash flows differ significantly from estimate at time acquire	19502	633	45497	41431	47.1	1.4
Pernod Ricard		Acquisition variances analysed each year & may result in write off	2138	95	20582	11992	17.8	0.5
Pinault Printemps	Allow 1 year to finalise		16229	451	108329	20241	80.2	0.4
PSA Peugeot			6532	268	221439	55768	11.7	0.1

Germany - Analysis of goodwill

Company Name	Accounting Standard	Immediate write off	Capitalize	Amortise	Period of amortisation	Notes	Method of Computing
AGIV	German	*	*	*	15 yrs	Cap from 1998. First year show gwl	Neg gwl write off reserves
Audi	German					No disclosure	
BASF	US		*	*	5-15 yrs. Straight line	Negative gwl in inc	
Bayer	IASC		*	*	5-20 yrs. Normally 5 yrs	Use IAS 22. Reverse companies sold to rev res.	Pur price-equities
Daimler Chrysler	US		*	*	3-40 yrs		
Degussa	US		*	*	15 yrs		76.2 negative gwl to rev reserves in previous years
Deutsche Babcock	German		*	*	Max 15 yrs Straight line	*	
Hochtief	German		*	*	10-15 years Straight line		Negative gwl w/off to reserves
Preussag	German		*	*	5-20 years Straight line. Period based on value.	*	Negative gwl w/off to reserves
Veba	US & IAS		*	*	8-15 yrs		Negative released if expected expenses

Germany - Analysis of goodwill

Company Name	How write up	Impairment review	Net B/s amount	P&L amount	Turnover	Equity	% of equity	P&L charge as % turnover
AGIV	BV method		133.7	9.6	4585.3	772.3	17.3	0.2
Audi			0	0	27222.1	2371.5	0.0	0.0
BASF	BV method		1079.7	284.5	54065	25268.2	4.3	0.5
Bayer		Reasses regularly and write down if necessary per IAS 36	2371	138	54884	24578	9.6	0.3
Daimler Chrysler		Assess recoverability -use projected future cash flows	4322.4	444.0	131782	30387	14.2	0.3
Degussa	BV method		179.8	15.2	15905.3	2568.8	7.0	0.1
Deutsche Babcock	BV method		536.5	25.4	8180.6	-42.7	-1256.4	0.3
Hochtief	BV method		24.4	2.8	6138.4	2445.3	1.0	0.0
Preussag	BV method		2284.8	123.9	35150.7	2570.8	88.9	0.4
Veba	BV method		2958	415	76365	23015	12.9	0.5

United Kingdom - Analysis of goodwill

Company Name	Immediate write off	Capitalise	Amortise	Period of amortisation	Notes	Impairment review	Method of Computing
Allied Domecq		*	*	Useful eco life	Not reinstate earlier gwl		
BAT		*	*	Useful eco life	Not reinstate earlier gwl		Adjustments
BNFL		*	*	20 yrs-Straight line	Not reinstate earlier gwl	End of 1st year and other times if events or changes in circumstances.	Excess of purchase consideration over fair value of identifiable assets and liab acquired.
BOC	*			N/A	Not yet adopt FRS 10	Diminution in P&L	As BNFL but to reserves
BP Amoco		*	*	20 yrs	Not change anything past	Yes if events or circumstances etc.	Fair value etc.
British Aerospace		*	*	Useful eco life Straight line	Capitalisation & wrote off to reserves in past.	As for BNFL	
BT		*	*	Useful eco life Max 20 yrs Straight line	Not reinstate earlier gwl		As BNFL
GUS		*	*	20 yrs Straight line	Not reinstate earlier gwl		As BNFL & also bring accounting policies into alignment with group before calculate gwl
Pilkington		*	*	Max 20 yrs but variances of 2 & 10 yrs	Reinstate gwl from after FRS 7- 1/4/95		Write off to share premium
Pennon		*	*	Useful eco life Straight line	Not reinstate earlier gwl		As BNFL

United Kingdom - Analysis of goodwill

Company Name	How write up	Pre-FRS 10 Write off to reserves-Bal £m after write backs	Write back to reserves if sell sub-£m	Net £/s amount	P&L amount	Turnover	Equity	% of equity	P&L charge as % turnover
Allied Domecq		2391	219	12	0	4103	2273	0.5	0.0
BAT		1793	Yes	0	0	17376	64	0.0	0.0
BNFL		119	Yes	482	0	1508	640	75.3	0.0
BOC	94.6m under US GAAP	162.6	Credit reserves	0	51.8	3549.9	1840.5	0.0	1.5
BP Amoco		0	0	60	14	83732	41786	0.1	0.0
British Aerospace		81	4	322	12	8611	2020	15.9	0.1
BT		1389	2214	742	0	18223	14940	5.0	0.0
GUS		1800.5	Yes	1503.5	72.6	5466.6	2409.1	62.4	1.3
Pilkington	Cost-fair MV	241	Yes	103	15	2709	742	13.9	0.6
Pennon		173.4	Yes	27.5	0.5	437.1	891.7	3.1	0.1

France - Analysis of leasing practices

Company Name	Acc. Std	Financial Lease			Operating Lease		Definition of Lease		
		Capitalise	Amortise	Notes	W/off to P&L	Notes only	Explicit	Implied	No definition
CGIP	IAS	*	*					*	
Eridania Beghin-Say	IAS	*	*					*	
Euro Disney	French			*	*	*		*	
France Telecom	French	*	*		*	*	*		
Gaz de France	French	*	*			*			*
Lafarge	IAS	*	*			*		*	
Legrand	US	*	*			*	*		
LVMH	US	*	*			*		*	
Pernod Ricard	French	*	*			*			*
Pinault Printemps	French			*	*	*			*
PSA Peugeot	US	*	*			*		*	

Germany - Analysis of leasing practices

Company Name	Acc.Std.	Financial Lease				Operating Lease		Definition of Lease		
		Capitalise	Amortise	Notes	No disclosure	W/off to P&L	Notes only	Explicit	Implied	No definition
AGIV	German				*	*				*
Audi	German			*	*		*			*
BASF	G=US			*	*					*
Bayer	IAS	*	*				*		*	
Daimler Chrysler	US	*	*				*	*		
Degussa	G=US				*		*			*
Deutsche Babcock	German				*		*			*
Hochtief	German				*					*
Preussag	German				*	*	*			*
Veba	G=US				*		*			*

United Kingdom - Analysis of leasing practices

Company Name	Financial Lease		Operating Lease	Definition of Lease	
	Capitalise	Amortise	W/off to P&L	Explicit	No definition but implied
Allied Domecq	NONE		*		*
BAT	*	*	*		*
BNFL	*	*	NONE		*
BOC	*	*	*		*
BP Amoco	*	*	*	*	
British Aerospace	*	*	*		*
BT	*	*	*		*
GUS	*	*	*		*
Pilkington	*	*	*		*
Pennon	*	*	*		*

France - Analysis of pension practices

Company Name	Accounting Standard	Types of pension schemes				Actuarial method of valuation					
		Defined Benefit		Defined Contributions	Other- Including Healthcare /Medical	No disclosure	Discount rate for liabilities	Rate of increase of future salaries	Inflation rate	Demographic / other assumptions	International companies
		Funded	Unfunded			% p.a.	% p.a.	% p.a.			
CGIP	French/ IAS	*	*						IAS 19		*
Eridania Beghin-Say	IASC		*		*				IAS 19	yes	*
Euro Disney	French	*	*	*	State funded plan						
France Telecom	French	*	*	*	Early retirement plan	4					
Gaz de France	French	*	*	*	Insurance policy						
Lafarge	IASC		*	*					IAS 19	yes	*
Legrand	F=US GAAP	*	*	*	Insur policy	4.5	2		FAS 87	yes-not material	*
LVMH	F=US GAAP	*	*	*					FAS 87 Germany- 6a		*
Pernod Ricard	French		*								
Pinault Printemps	French	*	*	*	*	4 to 4.5				yes	*
PSA Peugeot	French	*	*			6.5(French) 5.5 to 7 (other)		2	FAS 87	yes	*

France - Analysis of pension practices

Company Name	France - Financial Information					
	Equity	Bal Sheet Pension Provision FFm	% of equity	Turnover	P&L charge	P&L charge as % turnover
CGIP	13508	117.2	0.87	1893.3		0
Eridania Beghin-Say	20541	1356	6.60	64866		0
Euro Disney	7328	0	0.00	5895		0
France Telecom	111456	28760	25.80	161678	9696	6.00
Gaz de France	17633	900	5.10	58706	2611	4.45
Lafarge	29521	3550	12.03	64294		0.00
Legrand	7297	142	1.95	14278	62	0.43
LVMH	41431	974	2.35	45497	99	0.22
Pernod Ricard	11992	158	1.32	20582		0
Pinault Printemps	20241	548	2.71	108329		0
PSA Peugeot	55768	2228	4.00	221439	635	0.29

Germany - Analysis of pension practices

Company Name	Accounting Standard	Types of pension schemes				Actuarial method of valuation								
		Defined Benefit		Defined Contributions	Other- Incl. Health care /Medical	No disclosure	Rate of Return on Assets % p.a.	Discount rate for liabilities % p.a.	Rate of Increase of future salaries % p.a.	Rate of future Pension Increases % p.a.	Inflation rate % p.a.	Demographic/ other assumptions	International companies	Projected unit
		Funded	Unfunded											
AGIV	FAS 87	*			no	n/a	6.5	3	2.5	n/a	Heubeck		*(FAS 87)	
Audi	German	*	or *		n/a	n/a	5				Heubeck	G- art 6a		
BASF	FAS 87	*	or *	*	*	not disclosed	5.75	2.5	1.5	1.95(?)	Heubeck for G coys		*(FAS 87)	
Bayer - German scheme	IASC	*	*	*	*	7	6.5	2.5	2		Heubeck		* IAS 19	
- other countries		*	*	*	*	2.1 to 16.4	3 to 8.8	1 to 7	1 to 7					
Daimler Chrysler- US	FAS 87	*			*	9.7	6.5	5.9					* FAS 87	
- Non-US schemas	FAS 106 & 132	*			*	8.1	6	3.3			Heubeck		*	
Degussa	German	*	*		*		6.5	3	1.5	2 (?)	PK Chemie		*	
Deutsche Babcock	German	*	*		*		6				Heubeck	G- art 6a		
Hochtief	German	*	*		?		3.5				Heubeck			
Preussag	German	*	*		*		6					G- art 6a		
Veba	German	*	*	*	*in US		6	2.5	1		PK Chemie		*(FAS 87)	

Germany - Analysis of pension practices

Company Name	Germany - Financial Information					
	Equity	Bal Sheet Pension Provision DMm	% of equity	Turnover	P&L charge	P&L charge as % turnover
			%			%
AGIV	772.3	277.9	36.0	4585.3	88.3	1.9
Audi	2371.5	1886.1	79.5	27222.1	261.9	1.0
BASF	25268.2	7945.5	31.4	54065	603.6	1.1
Bayer - German scheme	24578	9225	37.5	54884	1803	3.3
- other countries						
Daimler Chrysler- US						
- Non-US schemes	30367	16618	54.7	131782	1126	0.9
Degussa	2568.8	1341.1	52.2	15905.3	231.3	1.5
Deutsche Babcock	-42.7	512.2	-1199.5	8180.6	63.2	0.8
Hochtief	2445.3	872.3	35.7	6138.4	77.1	1.3
Preussag	2570.8	1806.3	70.3	35150.7	227.1	0.6
Veba	23015	9476	41.2	76365	1135	1.5

United Kingdom - Analysis of pension practices

Company Name	Types of pension schemes			Actuarial method of valuation								
	Definad Benefit		Defined Contributions	Other-incl. Health care /Medical	Rate of Return on Assets % p.a.	Discount rate for liabilities % p.a.	Rate of increase of futura salaries % p.a.	Rate of futura Pension Increases % p.a.	Inflation rate % p.a.	Inter-national companies	Projected unit	Not disclosed
	Funded	Unfunded										
Allied Domecq	*				7.75	7.75	5.25	3				
-other esp US & C					>salary inc by 2% (US) & 2.5% (C)							
BAT	.	.	.	* US	4 to 9.5		5 to 7	4.5 to 5		Yes	.	
BNFL - Combined	.				2 net of pay incr.3.5% net of inflation							entry age
-BNFL Group					6.3(past)6.8 (future)		4.2	2.7			.	
- Electricity scheme					8.75		6	4.5			.	
-Westinghouse				.								
BOC -UK	.		.		3.6 > 3.5		2+3.5		3.5			
- US			.		2.7 + 3.8		1.7 + 3.8		3.8			
- Australia					3.5 + 3		1.5 + 3		3			
- South Africa					3.25+12.5		1.1+12.5		12.5			
BP Amoco- UK&Eur	.		.	* mainly US	7	7	5.1	3.2			.	
-USA			.		10	6.9	4.7	nil				
British Aerospace	.				4		2.5	4 to 5		yes	.	
BT	.				8 to 8.4		5.8		4		.	
					7.7	5.5	4.8					
GUS	.	.	.		6.06 to 7.55			3		yes	.	
-Argos schema	.				7.75			3.25			.	
Pilkington	.	.	.		4.8>salary					yes 2/3rd in UK	.	
Pennan Group	.	.	.		8.5		6.5	4.5 & 5			.	

United Kingdom - Analysis of pension practices

Company Name	UK - Financial Information						
	Equity	Bal Sheet Pension Provision £m	% of equity	Turnover	P&L charge	P&L charge as % turnover	% of fund to benefit liability
Allied Domecq	2273		0.0	4103	2	0.1	110
-other esp US & C					1		129
BAT	64	539	842.2	17376	95	0.5	75 to 162
BNFL - Combined	640		0.0	1508	17	1.1	132
-BNFL Group							105
- Electricity scheme					0		109.5
-Westinghouse					0		
BOC -UK	1840.5		0.0	3549.9		0.0	126
- US							133
- Australia							122
- South Africa							135
BP Amoco- UK&Eur	41786		0.0	83732	139	0.2	123
-USA							
British Aerospace	2020	25	1.2	8611	91	1.1	104
BT	14940	953	6.4	18223	176	1.0	100.3
GUS	2409.1	77.4	3.2	5466.6	29.7	0.5	105
-Argos scheme							106
Pilkington	742	156	21.0	2709	40	1.5	111
Pennon Group	891.7		0.0	437.1	1	0.2	127 & 149