PURPOSES AND CONTENTS OF ANNUAL FINANCIAL STATEMENTS AS SEEN BY VARIOUS NATIONALITIES

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Introduction

Differing views on the objectives and contents of financial statements have for many decades created problems for the business and accounting communities of the world. In recent years such differences have tended to compound, and at the same time have assumed greater significance with the continual increase in international trade and the development of transnational capital markets.

This article is concerned not only with identifying the nature of the differences that exist but, more importantly, with exploring the origins of the differences. An appreciation of the origins of the differences is an essential prelude in developing a solution to the present diversity in practice.

Surprisingly little has been written on the objectives of financial statements as envisaged by various nationalities, and the law and professional pronouncements of most countries have at best given cursory attention to the objectives underlying financial reporting. The need for clearly defined objectives has been perceived in a few countries but is not yet recognized in many others. Accordingly, it is generally necessary to review many aspects of financial reporting in order to identify the objectives that underlie financial statements in a particular country.

Auditors' Report

A significant clue regarding what is envisaged as the objectives of financial statements in a particular country is often embodied in the standard form of report used by auditors in that country. For this purpose countries can generally be divided into two broad categories. The first group embraces the concept of „fairness'' as a primary objective while the second stresses compliance with the „law'' and usually places greater emphasis on the form of financial statements than on the valuation methods reflected in the statements.

Although the precise terminology differs, the auditors' reports in use in Canada, the Netherlands, the United Kingdom and the United States all embrace the concept of „fairness''. Although there is no widely accepted definition of „fairness'', its most important ingredient is generally recognized to be impartiality. Impartiality acknowledges that financial statements are used by many parties - shareholders, creditors, employees, customers, suppliers, regulatory authorities - and as such must be fair to all users. An important feature of financial reporting in countries in which fairness is accepted as an aim is that it tends to be responsive to changing needs. This is significant in that few countries have the legislative or regulatory facilities to monitor and react to emerging problems on a continuous and timely basis.

Even where the concept of „fairness'' is accepted, it may have limited meaning. For instance, while in the Netherlands and in the United Kingdom „fairness" has been acknowledged as an overriding objective without reference to any prescribed code of accounting rules, in the United States it is viewed only in terms of conformity with generally accepted accounting principles rather than as an ultimate standard in itself. The Canadians have acknowledged this distinction by recognizing that auditors express two opinions - the first, and foremost, related to overall „fairness" and the second related to conformity with generally accepted accounting principles.

The concept of „fairness" is, however, far from being universally accepted as an aim in financial reporting and the auditors' reports in use in a number of countries say no more than that the financial statements conform with the law.

Which Assets and Liabilities Should Be Reported?

Those associated with financial reporting have not reached agreement as to which assets and liabilities should be admitted to the financial statements.

In the Netherlands, the question as to whether or not assets and liabilities should be admitted depends on whether such admittance is „regarded as being acceptable by the business community".

In other countries some have taken the position that an asset must possess „measurability", in the sense that its future economic benefits can be identified and objectively measured, before it may be properly included. For example, in the United States the Financial Accounting Standards Board has recently concluded that research and development expenditure should not be reported as an asset but should be expensed as incurred. The accounting profession in the United Kingdom appears about to reach a similar conclusion. In many other countries, research and development expenditures may be either expensed as incurred or capitalized and amortized over some period.

The accounting for purchased goodwill has been one of the most intractable accounting problems for years. Most countries have yet to prescribe for its accounting; in the meantime, it can be capitalized and retained without amortization, or can be written off immediately, or any one of a number of variations between these two extremes can be followed. In Canada, the United States and Germany, capitalization and mandatory amortization is presently required.

In the United States leased assets that are considered equivalent to installment purchases are required to be reported as assets and the related obligations must be reported as liabilities. No other country has yet adopted this requirement (although such accounting is followed in various countries), and most countries do not even require lease commitments to be disclosed.

Practices in recognizing obligations as liabilities also vary in a number of other respects. In many countries, certain employment costs are accounted for on the cash basis or on some other basis that does not recognize the entire liability. Examples are, semi-annual bonuses in Japan and vacations and pensions in Belgium. The cash basis is widely used to account for product warranty costs (for example in the United Kingdom and the United States). In Canada, it is generally regarded that a company must provide for product warranty costs in order to comply with the generally accepted accounting principle of accrual basis reporting.

Valuation of Assets

Consideration of the differences in approach to the valuation of assets serves to identify some fundamental differences in the objectives of financial statements among nations. While some countries adhere to historical cost or have attempted to reflect changes in the general price level by applying index factors to the historical cost base, others have developed systems that reflect current values for at least some assets.

The almost inviolable position of cost in the accounting fabric of most countries is curious if one reflects on accounting history. Historically, accountants set out to report value, and income was the product of the changing values of an entity's net assets. Historical cost was used as a surrogate for value in that it was easily verifiable. When prices moved only slowly over the years all was well. However, as time passed, the status of cost (which had earlier been viewed as a surrogate for value) was elevated to become an objective in itself. As a result the accounting laws and professional pronouncements of most countries became wedded to historical cost and in so doing abandoned what was useful for what was easily verifiable.

The abandonment of value as an objective was based on stable price levels. Such stability has of course become an illusion in that inflation has become a continuing feature of most economies and has worsened in recent years. The accelerating rate of inflation has led to the increasing use of three major valuation concepts - replacement value accounting, price-level accounting and value restatements.

In the Netherlands, replacement value accounting (whereby property, plant and equipment and inventories are restated to their replacement costs without recognizing gains or losses arising on net monetary assets or liabilities) has been adopted by many companies and is viewed as overcoming the principal shortcomings in historical cost accounting.

In the United Kingdom, supplementary price-level information is now published by a number of publicly traded companies. In Canada, the presentation of general price-level restatements in the form of supplementary information is encouraged. It is likely that the profession in the United States will in the near future issue recommendations regarding the presentation of price-level adjusted financial statements.

In the above countries, historical cost financial statements are still viewed as the primary statements and the statements expressed in current purchasing power are presented as supplementary data. Only Argentina and, to a certain extent South Africa, appear to be contemplating the complete replacement of historical cost primary statements with price-level statements. Further, price-level accounting is not indicated to be the ultimate in reporting but merely as a significant improvement over historical cost.

A few countries, notably Australia and the United Kingdom, acknowledging the limitations of historical cost, have permitted property, plant and equipment to be reported at „value". Thus, in the United Kingdom it has been common practice for some years to report property at appraised values.

Certain other countries have more formally recognized the impact of changes in prices on financial statements. Thus, the laws of France, Spain and many Latin American countries have required or permitted periodic adjustments of certain assets to reflect changing values in the light of inflation. After such adjustments have been recorded, they have permitted subsequent depreciation for tax purposes on that basis.

Conservatism

In a number of countries conservatism, generally motivated by creditor protection, has become intertwined with other factors as an element in the objectives of financial statements. Thus, in certain countries the requirements of company laws have often led to the use of accounting and reporting practices that do not agree with economic facts and in some cases have prohibited the use of sound accounting practices. An example of a practice that does not agree with economic facts and is permitted by the laws of some countries is the use of „hidden reserves" whereby a company may record reserves that are in addition to the reserves required to fairly report assets and liabilities. One country in which this practice is prevalent is Switzerland. There, the law allows a company's management to provide or reverse reserves to avoid reporting significant fluctuations in earnings. An example of a sound practice that is prohibited by the laws of some countries is the equity method of accounting for investments.

Influence of Tax Laws

The tax laws of certain countries have a significant effect on the way the business community views financial statements. This principally arises because the tax laws in many countries require conformity between accounting for tax and financial reporting purposes; thus, an expense may not be deducted for tax purposes until it is reflected in the financial statements and income cannot be declared for tax purposes in a period subsequent to that in which it is reported in the financial statements. Since the objectives of tax legislation rarely coincide with fair presentation, this leads to a significant degradation in financial reporting. France, Germany and Japan are the principal examples of countries in which conformity with the tax law is a dominant factor in financial reporting.

The tax laws of many countries provide for accelerated tax depreciation and permit other conservative valuation practices. As a result, financial statements tend to be more conservative in countries in which tax and financial reporting are the same. However, this is not always the case and there are many examples of tax requirements that tend to lead to less conservative presentations. In many countries, reserves for bad debts and inventory obsolescence are not deductible for tax purposes until losses on the specific items concerned become virtually certain. Consequently, general reserves based on past experience are frequently not recorded. In Japan only part of a company's liability for retirement and other employee severance benefits is deductible for tax purposes as it accrues. As a result, many companies only accrue the tax-deductible portion of their liabilities for these benefits although their actual obligations are much greater. In the United Kingdom, depreciation on most properties is not deductible for tax purposes. This, undoubtedly, has been an important reason why the majority of companies do not provide for depreciation on buildings.

Thus, in countries in which the law requires conformity between tax and financial reporting, such conformity in itself frequently becomes viewed as an objective of financial statements. Even where it is not so viewed, the business communities in some countries have long ceased to view published financial statements as meaningful presentations with the result that there is little or no impetus to improve financial reporting.

Company Law

In certain countries, financial reporting is dominated by the company law to such a degree that conformity with the law has become virtually synonymous with the objectives of financial statements. In such countries, the law frequently specifies which assets and liabilities are to be reported, how they should be valued, and the form and content of the financial statements. This essentially legalistic approach to financial reporting is exemplified in the laws of France, Germany and Japan.

A particularly adverse aspect of legislative encroachment on accounting is the tendency for legal provisions to become regarded as the ultimate in reporting. Business tends to conclude that as long as its reporting conforms with the law its responsibilities are fulfilled. As a result, the law may assume a sanctity that becomes a positive hindrance to progress.

Contents of Financial Statements

For many years there existed a broad consensus on the basic content of financial statements in that a balance sheet, an income statement and notes to financial statements have generally been recognized as the basic ingredients. The major differences between nations have been in the amount of detail shown in the financial statements and the nature and extent of supporting and peripheral financial data provided.

In the Netherlands, the Law on Annual Accountants of Enterprises dictates that annual financial statements should provide such information as is required to enable the reader to form a sound judgment on the financial position and results of operations and, to the extent to which financial statements are capable of so doing, on its solvency and liquidity. The law prescribes certain minimum requirements as to the detail of the accounts to be presented and as to certain footnote information. It does not require a prescribed format for financial reporting, as is the case in France and Germany. In these countries, the laws also provide for considerable detail to be furnished.

The most significant differences in the content of financial statements are found in the area of supplemental financial data. In the United States, generally accepted accounting principles and, where applicable, the Securities and Exchange Commission, require elaborate disclosures in many areas of reporting. The pattern and extent of the required disclosures reflect the many demands for corporate forthrightness that has long been a feature of the American business scene. Extensive though such requirements are, they are likely to increase. The extent of required supplemental disclosures is less in such countries as Australia, Canada, the Netherlands and the United Kingdom than it is in the United States. In a number of countries, including Belgium, Brazil, Italy, Spain and Switzerland, few disclosures are prescribed by the law and corporations rarely disclose anything not required by the law.

Two major developments have occurred in recent years that are now beginning to produce important additional differences in the content of financial statements. These are the presentation of supplementary price-level information previously discussed and the presentation of a funds statement. A funds statement is now a required financial statement in Canada, the United Kingdom and the United States. It is likely that a number of other countries will follow suit in this regard.

National Scenes

The divergence in national positions outlined in the preceding paragraphs may be illustrated by a brief view of significant current trends in the major industrialized nations.

Canada

Developments in Canada have tended to mirror those in the United Kingdom and the United States. Until the 1960's, financial reporting was largely influenced by statute but since then the pronouncements of the Canadian Institute have been the most dominant factor in improved reporting. The „Accounting guidelines on accounting for the effect of changes in the purchasing power of money" state as a principle that „financial statements should continue to be prepared and presented on the conventional basis of historical cost", while, as previously stated, presentation of price-level restatements as supplemental information is encouraged.

France

The law governing commercial companies and the tax law dominate financial reporting in France and there are few signs that this is about to change. The Plan Contable Général provides for a standard form of financial statements and exhibits. It also contains rules for the valuation of assets, although such rules are not mandatory. Historical cost prevails although the law has periodically attempted to recognize significant changes in value by permitting ad hoc restatements of certain assets. One welcome development is that the authorities appear increasingly anxious to elevate reporting standards and are providing increasing support to the accounting profession.

Germany

Financial reporting has long been dominated by the law, and the accounting profession has largely confined itself to developing interpretations of the law. Financial reporting continues to be dominated by tax regulations.

Japan

Japan is making considerable progress in elevating reporting standards which until recent years have not been compatible with an advanced industrial nation. Most companies present their financial statements on a tax basis because of tax conformity requirements in many areas with accounting record keeping, and their financial reporting. As a result, the accounting profession and business community generally view any accounting practice permitted by tax law, including the overstatement of assets and understatement of liabilities, as being acceptable for financial reporting purposes. However, many are becoming increasingly conscious of this impediment to progress in financial reporting and are seeking ways to present more meaningful financial reports.

The Netherlands

The accounting profession in the Netherlands has for many years recognized the limitations of historical cost and many companies have adopted various forms of replacement cost accounting. Although replacement cost accounting as used in the Netherlands does not purport to represent a value approach, it is likely that much of the technology used in replacement cost accounting will become widely used, not only in the Netherlands but in other countries as well, as accounting moves away from historical cost. The accounting profession has devoted considerable energy to the development of improved standards and in attempting to identify the objectives of financial statements.

United Kingdom

In the United Kingdom, practice has for many years recognized the limitations of historical cost where the value of property has changed dramatically, and, as previously discussed, it has been common practice for some years to report properties at appraised values. In recent years, much effort has been expended in further modifying the historical cost principles to reflect significant inflation, with the result that most publicly traded companies provide at least a summary of the impact of inflation on their financial statements. In addition, the objectives of financial statements are now under formal study by various groups within the accounting profession with some indication that they will move further toward the value concept.

United States

The scene in the United States is one of contradiction. While generally accepted accounting principles and the regulatory authorities regard historical cost as more sacrosanct than in most countries, the accounting profession is spending considerable effort in attempting to decide whether it should depart from cost and, if so, how. The publication in 1973 of the report of the Study Group on „Objectives of Financial Statements" (a group appointed by the AICPA in 1971) marked the culmination of an enormous endeavour to develop a new language of reporting. The Study Group was very concerned with the development of proper measurement techniques and the inherent uncertainties in some values. Its report concluded that changes in value between periods should be reported, provided there is clear disclosure and segregation of assets and liabilities whose value reliability is uncertain. The new Financial Accounting Standards Board is using this report as a basis for its own current deliberations.

Towards a Solution

As previously indicated, many factors have contributed to the present differences in accounting and reporting practices. They include the influence of tax laws, the provisions of company laws, the requirements of governmental and other regulatory bodies and the differences in practices recommended by the accounting professions.

Although some diversity in practice is inevitable, it is becoming increasingly evident that the differences in the objectives and content of financial statements that presently exist are so fundamental that they have become a significant impediment to international business and the transnational capital market. Disenchantment with traditional reporting standards is in evidence in many countries, but there is as yet little progress towards a common solution on accounting fundamentals.

I will not attempt a detailed solution to our dilemmas, but the present diversity in practice is such that the most urgent need can be identified. In this regard, it must be acknowledged that the challenge facing the accounting professions is greater than accounting harmonization. Although the emulation of current best practice is clearly needed, such harmonization cannot proceed very far without consideration of what is „ best practice", and this remains unanswered. It is therefore clear that the most critical need facing the accounting professions of the world is the establishment of a system of accounting and reporting that is based on clearly identified objectives that provide a basis of choice between existing practices and act as a foundation for the development of new standards.