



# chapter

## COMPARATIVE ACCOUNTING II

**C**hapter 3 looked at accounting in six economically developed countries. All six have well-established mechanisms for developing accounting and auditing standards that provide comprehensive guidance for financial reporting and auditing. The four countries examined in this chapter are commonly referred to as emerging economies.<sup>1</sup> They are the Czech Republic, People's Republic of China (China), Republic of China (Taiwan), and Mexico.

The Czech Republic and China are converting from centrally planned economies to ones that are more market oriented. However, the extent to which they are embracing market reforms is different. The Czech Republic is moving toward a complete market economy, while China is taking a middle course in moving to a *socialist market economy*, that is, a planned economy with market adaptations. Both countries are finding it necessary to completely overhaul their accounting systems. Since the Czech Republic and China are taking different approaches to restructuring their respective economies, they are also taking different approaches to restructuring their accounting systems. Both efforts began in the 1990s and are constantly changing.

Taiwan and Mexico are capitalist countries but with traditionally heavy central government intervention and government ownership of key industries. Historically, their economies have been somewhat closed to foreign investment and international competition. This relative isolation is now changing, as both governments are privatizing their industry holdings and opening up to the global economy. Their financial accounting systems are more developed in terms of standard setting, requirements, and practices than the Czech Republic and China. Naturally, evolution in accounting is occurring in these two countries as well, but not as rapidly as in the Czech Republic and China.

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<sup>1</sup>The term "emerging economies" refers loosely to newly industrialized countries (NICs) and those countries in transition from planned to free-market economies. NICs have experienced rapid industrial growth, but their economies are not yet rich in terms of per capita gross domestic product. Mexico and Taiwan are NICs and China and the Czech Republic have economies in transition.

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## REASONS FOR CHOOSING THESE FOUR COUNTRIES

Why did we choose these four countries to survey? China may be obvious: It is the most populous country in the world. Companies from all around the world are eager to do business with China, and its accounting developments are an important part of the structural changes in its economy.

We wanted to include a former member of the Soviet bloc. We chose the Czech Republic because accounting developments there are representative of those in other former Soviet bloc countries.

Taiwan is a so-called “Asian Tiger,” one of several Asian countries experiencing rapid growth in gross domestic product in recent years, led by growth of industrial exports. Other such countries include Hong Kong (returned to China by Great Britain in 1997), South Korea, and Singapore. We think that Taiwan’s historical and cultural connection to (mainland) China adds interest because of the very different directions that accounting has taken in these two economies.

Finally, we wanted to include a Latin American country. Throughout most of Latin America, a decade of free-market reforms has led to healthier economic fundamentals, such as lower inflation and faster economic growth. Protectionist barriers to imports have been dismantled for the most part, economic nationalism has been replaced by a welcoming of foreign investment, and state-owned companies are being privatized. These reforms have gone furthest in Argentina, Chile, Mexico, and Peru, and they are gathering pace in Brazil, Colombia, and Venezuela.<sup>2</sup> We chose Mexico because the 1994 North American Free Trade Agreement (NAFTA) created much new interest in Mexican accounting in Canada, the United States, and elsewhere. Accounting in Mexico shares many features of accounting with other Latin American countries.

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## SOME OBSERVATIONS ABOUT THE FOUR COUNTRIES AND THEIR ACCOUNTING

Exhibit 4-1 contains some comparative economic data about the four countries that are the focus of this chapter. China’s area, population, and resulting gross domestic product (GDP) obviously dwarf the other three. However, China’s imports and exports relative to GDP show how insular the Chinese economy is now. Taiwan stands in stark contrast: Trading with the rest of the world is significant to its economy. Another contrast is GDP per capita and by sector. Overall, China is significantly poorer than the other three nations and its economy is much more agricultural. Both of these are signs of significant development potential. Per capita GDP shows that Taiwan has a relatively high standard of living. The Czech Republic and Mexico are comparable, but lower. “Services” is the most important part of the economies of the Czech Republic, Taiwan, and Mexico.

The information on major trading partners reveals a pattern that is true in general, namely, that most international trade is regional in nature. This is most obvious with Mexico, where the United States accounts for more than three-fourths of Mexico’s imports and exports. Most of the Czech Republic’s trading is with neighboring countries,

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<sup>2</sup> *The Economist*, “Back on the Pitch: A Survey of Business in Latin America,” (December 6, 1997): 3–4.

**EXHIBIT 4-1 Economic Data**

	<i>Czech Republic</i>	<i>China</i>	<i>Taiwan</i>	<i>Mexico</i>
Area in Sq.Km.	79 thousand	9.56 million	36 thousand	1.97 million
Population	10.3 million	1.26 billion	21.9 million	95.8 million
Gross Domestic Product	\$53 billion	\$924 billion	\$262 billion	\$368 billion
GDP Per Capita	\$5,150	\$750	\$12,040	\$3,840
GDP by Sector				
Agriculture	4%	18%	3%	6%
Industry	42%	49%	34%	26%
Services	54%	33%	63%	68%
Imports	\$28.8 billion	\$140.3 billion	\$104.7 billion	\$125.4 billion
Exports	\$26.4 billion	\$183.6 billion	\$110.6 billion	\$117.5 billion
Major Trading Partners	Germany, Slovakia, Austria, Russia	Japan, Hong Kong, U.S., Taiwan, S. Korea	U.S., Japan, Hong Kong	U.S., Japan

Source: *Pocket World in Figures 2001*, London: The Economist, 2000.

as is much of China's. This pattern is less true with Taiwan, since the United States is Taiwan's largest trading partner.<sup>3</sup>

Exhibit 4-2 has other data concerning the number of Top 200 emerging market companies<sup>4</sup> and use of the London and New York Stock Exchanges and NASDAQ for raising capital. The number of Top 200 companies indicates that the economies and stock markets of Taiwan and Mexico are relatively more developed than those of the Czech Republic and China. The listing patterns show that Chinese and Mexican companies prefer the New York over the London Stock Exchange, while the reverse is true for companies from the Czech Republic and Taiwan. Overall, few companies from the four countries discussed in this chapter have listed on NASDAQ.

As you read about accounting in the four countries in this chapter, keep in mind the factors affecting accounting development that were discussed in Chapter 2: (1) sources of finance, (2) legal system, (3) taxation, (4) political and economic ties, (5) inflation, (6) level of economic development, (7) education level, and (8) culture. Their influence on accounting in nations with developed economies should be clear from reading Chapter 3. Do they also explain accounting in developing countries? We think so. However, the relative importance of certain factors may be quite different in developing economies than in developed ones, and the influences may appear in different ways.

To illustrate, the effect of the type of legal system is less important in the countries discussed in this chapter than the ones in Chapter 3. For example, Mexico has a civil law

<sup>3</sup>The anomaly has a historical explanation, as discussed later in this chapter in the section on Taiwan. When the Nationalists on mainland China fled to Taiwan in 1949 following the Communist victory on the mainland, the United States soon began providing substantial amounts of economic development aid to Taiwan. Trade with mainland China was out of the question, and the other countries in the region, including Japan (still recovering from World War II), were too poor and underdeveloped. The link to the United States remains to this day.

<sup>4</sup>Based on market capitalization expressed in U.S. dollars.

**EXHIBIT 4-2 Other Data**

	<i>Czech Republic</i>	<i>China</i>	<i>Taiwan</i>	<i>Mexico</i>
No. of Top 200 emerging market companies <sup>a</sup>	1	3	34	13
No. of companies listed on London Stock Exchange <sup>b</sup>	4	5	13	0
No. of companies listed on New York Stock Exchange <sup>c</sup>	0	13	3	29
No. of companies listed on NASDAQ <sup>d</sup>	0	0	3	3

<sup>a</sup> Source: *Business Week*, (July 10, 2000): 149–150, 151.

<sup>b</sup> Source: London Stock Exchange Web site (<http://www.londonstockexchange.com>), November 30, 2000.

<sup>c</sup> Source: New York Stock Exchange, Web site (<http://www.nyse.com>), December 20, 2000.

<sup>d</sup> Source: NASDAQ Web site (<http://www.nasdaq.com>), January 30, 2001.

legal system similar to that in France and other Continental European countries, yet accounting in Mexico is oriented toward fairness, not legal compliance. Political and economic ties are arguably more important for the countries in this chapter. Mexico's substantial economic contact with the United States, which extends to accounting, explains why Mexico has fairness-oriented accounting. The United States has similar influence in Taiwan. In the Czech Republic, the effect of political and economic ties is more anticipatory than historical. European Union Directives provide the framework for the development of accounting principles, because the Czech Republic has applied for EU membership. China is basing its new accounting standards on International Accounting Standards, because it hopes to better communicate with foreign investors who are vital to its economic development plans.

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## FOUR NATIONAL FINANCIAL ACCOUNTING SYSTEMS<sup>5</sup>

### Czech Republic

The Czech Republic (CR) is located in Central Europe with Germany to the west and northwest, Austria to the south, the Slovak Republic to the east, and Poland to the north. Its territory was a part of the Austro-Hungarian Empire for nearly 300 years (from 1620 to 1918), ruled by the Austrian monarchy, the Hapsburgs. The empire collapsed at the end of World War I, and the independent nation of Czechoslovakia was formed in 1918. Between the two World Wars, Czechoslovakia was a prosperous parliamentary democracy with universal voting rights. This ended in 1938 when Britain and France allowed Nazi Germany to annex Czechoslovakia's ethnically German border territories. Within a year, Hitler controlled the rest of the nation and the Nazi occupation began. The 1946 elections and subsequent political maneuvering brought the Communist Party to power. This began the Soviet Union's domination over Czechoslovakia, which lasted

<sup>5</sup>The discussion in this section draws on the references cited at the end of the chapter.

until 1989. The internal disintegration of the Soviet regime and the collapse of the Czechoslovak Communist government in that year led to the so-called “Velvet Revolution” and the formation of a new government. In 1993 Czechoslovakia peacefully split into two nations, the Czech Republic and the Republic of Slovakia.

Accounting in the Czech Republic has changed direction several times in the twentieth century, reflecting its political history. Accounting practice and principles reflected those of the German-speaking countries of Europe until the end of World War II. Then, as a centrally planned economy was being constructed, accounting practice was based on the Soviet model. The administrative needs of various central government institutions were satisfied through such features as a uniform chart of accounts, detailed accounting methods, and uniform financial statements, obligatory for all enterprises. The focus on production and costing, based on historical costs, was emphasized over external reporting. A unified system of financial and cost accounting used the same pricing and other principles.

Of course, prices did not reflect the market forces of supply and demand. They were centrally determined and controlled, primarily on the *cost plus* basis. Losses were normally subsidized. Accounting was of limited importance in managing an enterprise. Furthermore, accounting information was considered to be secret and financial statements were not published. Although accounting information was inspected, it was not independently audited.<sup>6</sup>

After 1989 Czechoslovakia moved quickly toward a market-oriented economy. The government revamped its legal and administrative structure to stimulate the economy and attract foreign investments. Commercial laws and practices were adjusted to fit Western standards. Price controls were lifted. Accounting again turned westward, this time reflecting the principles embodied in the European Union Directives.

The division of Czechoslovakia did not appreciably affect this process. In 1993 the Prague Stock Exchange began regular operations. Considering the high level of economic and political development achieved in pre-1938 Czechoslovakia, these events were more a matter of returning to previously held norms than discovering new ones.<sup>7</sup>

Privatization of the economy involved the return of property to former owners, small privatizations in which more than 20,000 shops, restaurants, and other small businesses were sold to Czech citizens by public auction, and a series of large privatizations. A key element of the latter was an innovative coupon voucher system allowing adult Czech citizens to buy investment vouchers for a nominal price. These vouchers were used to acquire shares of newly privatized large industrial concerns. However, the privatizations have yet to cause widespread industrial restructuring. Many Czechs, with no experience as shareholders, sold their shares to investment funds owned by state-controlled Czech banks. One result was a conflict of interest for the banks, which ended up owning the same companies to whom they were lending money. The economic reforms are ongoing. Further privatizations, including the banking sector, are in the works. Among the more pressing issues are strengthening the bankruptcy laws, improving the

<sup>6</sup>Rudolf Schroll, “The New Accounting System in the Czech Republic,” *European Accounting Review* 4, no. 4 (1995): 827–832; and Jan Dolezal, “The Czech Republic,” in *European Accounting Guide*, 2nd ed., David Alexander and Simon Archer, eds., San Diego: Harcourt Brace Jovanovich, 1995.

<sup>7</sup>Willie Seal, Pat Sucher, and Ivan Zelenka, “The Changing Organization of Czech Accounting,” *European Accounting Review* 4, no. 4 (1995): 667.

openness and transparency of stock market operations through tighter regulations, and restructuring enterprises.<sup>8</sup>

In 1995 the Czech Republic became the first post-Communist member of the OECD. The Czech Republic joined NATO in 1999 and hopes to achieve full membership in the European Union by 2003.

### Accounting Regulation and Enforcement

The new Commercial Code was enacted by Parliament in 1991 and became effective on January 1, 1992.<sup>9</sup> Influenced by the Austrian roots of the old commercial code and modeled on German commercial law, it introduced a substantial amount of legislation relating to businesses. (Czech law is based on the civil code law system of continental Europe.) This legislation includes requirements for annual financial statements, income taxes, audits, and shareholders meetings.

The Accountancy Act that sets out the requirements for accounting was passed in 1991 and became effective on January 1, 1993. Based on the EU Fourth and Seventh Directives, the act specifies the use of a chart of accounts for record keeping and the preparation of financial statements.<sup>10</sup> The Ministry of Finance is responsible for accounting principles. Ministry of Finance decrees set out acceptable measurement and disclosure practices that companies must follow. Thus, accounting in the CR is influenced by the Commercial Code, the Accountancy Act, and Ministry of Finance decrees. The Stock Exchange has so far had little influence and, despite the German origins of the Commercial Code, tax legislation is not directly influential. As discussed in the following section, the *true and fair view* embodied in the Accountancy Act and taken from EU Directives is interpreted to mean that tax and financial accounts are treated differently.<sup>11</sup> Nevertheless, legal form takes precedence over economic substance in many cases.

Auditing is regulated by the Act on Auditors, passed in 1992. This act established the Chamber of Auditors, which oversees the registration, education, examination, and disciplining of auditors, the setting of auditing standards, and the regulation of audit practice, such as the format of the audit report. An audit of financial statements is required for all corporations (joint stock companies) and for large limited liability companies (those with prior year turnover exceeding CzK40 million or net assets exceeding

<sup>8</sup>U.S. Department of State, "Background Notes: Czech Republic" (March 1999): 10; U.S. Central Intelligence Agency, "The World Factbook 2000—Czech Republic" (2000), 6; Daniel Michaels and John Reed, "Halfway There," *Wall Street Journal Interactive Edition* (September 18, 1997): 1–6; Mark Andress, "Czech, Please!," *Accountancy* (September 2000): 60–61.

Czech capital markets are largely illiquid. In 1995 and 1996, after the initial large privatizations, there were over 1,600 Czech companies listed on the Prague Stock Exchange. However, in 1997 the exchange started delisting securities that were rarely traded. By the end of 1999, the Prague Stock Exchange had approximately 200 listed companies. See Pat Sucher, Peter Moizer, and Marcela Zarova, "The Images of the Big Six Audit Firms in the Czech Republic," *European Accounting Review* 8, no. 3 (1999): 503, 519; and *Prague Stock Exchange Factbook*, Prague: PSE, 2000, 29.

<sup>9</sup>In 1991 legislation was passed by the then-Czechoslovak Parliament. The Czech Republic carried forward its provisions after the division.

<sup>10</sup>Charts of accounts are not new to the Czech Republic because their use was required under Communism. The Czechs based their new system on the French Plan Comptable and received substantial help from the French Ministry of Finance and the French accounting profession in developing their new charts of account.

<sup>11</sup>Pat Sucher, Willie Seal, and Ivan Zelenka, "True and Fair View in the Czech Republic: A Note on Local Perceptions," *European Accounting Review* 5, no. 3 (1996): 551.

CzK20 million).<sup>12</sup> The audit is designed to assure that the accounts have been kept according to applicable legislation and decrees and that the financial statements present a true and fair view of the company's financial position and results.<sup>13</sup>

### Financial Reporting

The accounting period is required to be the calendar year. Financial statements must be comparative, consisting of:

1. Balance sheet
2. Profit and loss account (income statement)
3. Notes

Consistent with the requirements of EU Directives, the notes include a description of the accounting policies and other relevant information for assessing the financial statements. Examples of the latter include employee information, revenues by segment, and contingencies. The notes must also include a cash flow statement. Consolidated financial statements are required for groups with equity in excess of CzK300 million or revenues in excess of CzK600 million. Controlling interest in a subsidiary is based on either owning a majority of shares or having a direct or indirect dominant influence. In general the requirements for consolidated financial statements are the same whether or not a company is listed on the Prague Stock Exchange. However, small and other companies not subject to audit have abbreviated disclosure requirements. Financial statements are approved at the annual meeting of shareholders. Listed companies are also required to present quarterly financial statements and audited annual financial statements according to International Accounting Standards.

### Accounting Measurements

The acquisition (purchase) method is used to account for business combinations. Goodwill arising from a business combination is written off in the first year of consolidation or capitalized and amortized over 5 years. The equity method is used for associated companies (those over which the company exercises significant influence but which are not consolidated) and for joint ventures. The year-end (closing) exchange rate is used to translate both the income statement and balance sheet of foreign subsidiaries. There are no guidelines for reporting foreign currency translation adjustments.

Tangible and intangible assets are valued at cost and written off over their expected economic lives, with a 5-year maximum for intangibles. Inventory is valued at cost, and FIFO and weighted average are allowable cost flow assumptions (LIFO is not). Research and development costs may be capitalized if they relate to projects completed successfully and capable of generating future income. Leased assets are typically not capitalized, an example of form over substance. Deferred income taxes are only recognized for the difference between accounting and tax depreciation. Contingent losses are

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<sup>12</sup>Corporations issue shares whereas limited liability companies do not. The latter are similar to limited partnerships.

<sup>13</sup>For further discussion of the development of auditing in the Czech Republic, see Pat Sucher and Ian Zelenka, "The Development of the Role of the Audit in the Czech Republic," *European Accounting Review* 7, no. 4 (1998): 723–751. The study also documents difficulties in getting Czech companies to comply with the requirements for audited financial statements. Thus, information is often unavailable to potential investors, even for publicly traded companies.

recorded when they are probable and can be reliably measured. Legal reserves are also required: Profits are appropriated annually until they reach 20 percent of equity for corporations and 10 percent for limited liability companies.

## China<sup>14</sup>

China has a quarter of the world's population, and market-oriented reforms have recently helped generate rapid economic growth. In the late 1970s, Chinese leaders began to move the economy from Soviet-style central planning to one that is more market-oriented but still under Communist Party control. To achieve this, authorities switched to a system of household responsibility in agriculture instead of the old collectivization, increased the authority of local officials and plant managers in industry, permitted a wide variety of small-scale enterprises in services and light manufacturing, and opened the economy to increased foreign trade and investment. In 1993 China's leadership approved additional long-term reforms aimed at giving more flexibility for market-oriented institutions. Central features include the share system of ownership, privatizations, the development of organized stock exchanges, and the listing of shares in Chinese companies on Western exchanges. Nevertheless, state enterprises still continue to dominate many key industries in what the Chinese call a "socialist market economy," that is, a planned economy with market adaptations.

Accounting in China has a long history. Its functioning in a stewardship role can be detected as far back as 2200 B.C. during the Hsiu Dynasty, and documents show that it was used to measure wealth and compare achievements among dukes and princes in the Xia Dynasty (2000 to 1500 B.C.). The young Confucius (551 to 479 B.C.) was a manager of warehouses and his writings mention that the job included proper accounting—keeping the records of receipts and disbursements up-to-date. Among the teachings of Confucius is the imperative to keep history, and accounting records are viewed as part of that history.

The principal characteristics of accounting in China today date from the founding of the People's Republic of China in 1949. China installed a highly centralized planned economy, reflecting Marxist principles and patterned after that of the Soviet Union. The state controlled the ownership, the right to use, and the distribution of all means of production, and enacted rigid planning and control over the economy. Production was the top priority of state-owned enterprises. Their sales and pricing were dictated by the state's planning authorities, and their financing and product costing were administered by the state's finance departments. Under this system, the purpose of accounting was to serve the needs of the state for economic planning and control. A uniform set of standardized accounts was developed to integrate information into the national economic plan. The uniform accounting system contained all-inclusive accounting rules that were mandatory for state-owned enterprises across the country.

Financial reporting was frequent and detailed. The main feature was a fund management orientation where *funds* meant the property, goods, and materials used in the

<sup>14</sup>In 1997, Great Britain ceded control of Hong Kong to China. Under the agreement between China and Britain, China has guaranteed to operate a "one country, two systems" arrangement in which Hong Kong's lifestyle will be unchanged for 50 years and basic freedoms and rights will be guaranteed by law. Accounting in Hong Kong is similar to that of the United Kingdom, described in Chapter 3. The discussion of China in this chapter refers to mainland China and excludes Hong Kong.

production process. Financial reporting emphasized the balance sheet, which reflected the source and application of funds. It focused on stewardship and accountability, or the fulfilling of production and other goals, as well as compliance with governmental policies and regulations. Accounting emphasized counting quantities and the comparison of costs and quantities. Although accounting focused more on managerial than financial objectives, its role in decision making by the managers of individual enterprises was nevertheless subordinated to the central authorities.

China's economy today is best described as a hybrid economy in which the state controls strategic commodities and industries, while other industries, as well as the commercial and private sectors, are governed by a market-oriented system. The recent economic reforms involve privatizations, including the conversion of state-owned enterprises into share-issuing corporations. New accounting rules have had to be developed for newly privatized companies and other independent limited liability companies, as well as for foreign business entities such as joint ventures. The role of the government has been changing from managing both the macro- and microeconomy to one managing at the macro level only.<sup>15</sup> Accounting standards were needed to reflect this new reality.

### Accounting Regulation and Enforcement

The Accounting Law was amended in 1993 and 1999, and covers all enterprises and organizations including those not owned or controlled by the state. It outlines the general principles of accounting and defines the role of the government and the matters that require accounting procedures. The Ministry of Finance formulates accounting and auditing standards. This agency is supervised by the State Council, an executive body corresponding to a cabinet. Besides accounting and auditing matters, the ministry is responsible for a wide range of activities affecting the economy. Generally, these activities include formulating long-term economic strategies and setting the priorities for the allocation of government funds. More specifically, the ministry's responsibilities include:

- formulating and enforcing economic, tax, and other finance-related policies
- preparing the annual state budget and fiscal report
- managing state revenue and expenditure
- developing the financial management and tax system<sup>16</sup>

Accounting and auditing matters fall into the last category.

In 1992 the Ministry of Finance issued Accounting Standards for Business Enterprises (ASBE), a conceptual framework designed to guide the development of new ac-

<sup>15</sup>The ownership relationship between the government and state-owned enterprises has been redefined. Regulations issued by the Ministry of Finance in 1994 announced for the first time that the state is an investor in the enterprise and is responsible for the enterprise's debts limited to the amount of its capital; the enterprise has its own legal status, enjoying its own property rights and bearing independent civil responsibilities. See Zezhong Xiao and Aixiang Pan, "Developing Accounting Standards on the Basis of a Conceptual Framework by the Chinese Government," *The International Journal of Accounting* 32, no. 3 (1997): 282. For further discussion of China's reforms of state-owned enterprises, see "The Longer March," *The Economist* (September 30, 2000): 71-73.

<sup>16</sup>"Role of the Ministry of Finance," Ministry of Finance Web site (<http://www.mof.gov.cn>), December 16, 2000.

counting standards. These standards will eventually harmonize domestic practices and harmonize Chinese practices with international practices. Effective on July 1, 1993, the ASBE is a landmark event in China's move to a market economy. Before the ASBE, more than 40 different uniform accounting systems were in use, varying across industries and types of ownership. Even though each one of these may individually be labeled as *uniform*, they resulted in inconsistent practices overall. Thus, one motive for issuing the ASBE was to harmonize domestic accounting practices. Moreover, existing practices were incompatible with international practices and unsuited for a market-oriented economy. Harmonizing Chinese accounting to international practices serves to remove barriers of communication with foreign investors and helps meet the needs of the economic reforms already under way. Exhibit 4-3 summarizes the ASBE.

After the issuance of the ASBE, the Ministry of Finance replaced the more than 40 uniform accounting systems mentioned previously with thirteen industry-based and two ownership-based accounting systems, as listed in Exhibit 4-4. These systems are viewed as transitional until specific accounting standards can be promulgated that will apply to all enterprises operating in China.

The China Accounting Standards Committee (CASC) was established in 1998 as the authoritative body within the Ministry of Finance responsible for developing accounting standards. The standard-setting process includes assigning necessary research to task forces, the issuance of exposure drafts, and public hearings. CASC members are experts drawn from academia, accounting firms, government, professional accounting associations, and other key groups concerned with the development of accounting in China. To date, the CASC has issued 10 accounting standards on issues such as cash flow statements, debt restructuring, revenue, nonmonetary transactions, and contingencies.<sup>17</sup>

The China Securities Regulatory Commission (CSRC) regulates China's two stock exchanges: Shanghai, which opened in 1990, and Shenzhen, which opened in 1991. It sets regulatory guidelines, formulates and enforces market rules, and authorizes initial public offers and new shares. The CSRC also issues additional disclosure requirements for listed companies. Thus, disclosure requirements for listed companies are established by two government bodies, the Ministry of Finance and the CSRC.

Until 1995 China had two professional accounting organizations. The Chinese Institute of Certified Public Accountants (CICPA), established in 1988 under the jurisdiction of the Ministry of Finance, regulated the audit of private sector enterprises. The Chinese Association of Certified Public Auditors (CACPA) was responsible for auditing state-owned enterprises and was under the authority of a separate organization, the State Audit Administration. In 1995 CICPA and CACPA merged, keeping the name of the CICPA.

The CICPA sets the requirements for becoming a CPA, administers the CPA examination, develops auditing standards, and is responsible for the code of professional ethics. With the exception that the CICPA reports to a government agency, the regulation of public accounting practice in China may be compared to the system in the United States.

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<sup>17</sup>Stephen Taylor, "Standard Bearer," *Accountancy* (August 2000): 115.

### EXHIBIT 4-3 Accounting Standards for Business Enterprises

#### *Orientation*

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- A uniform accounting system conforming to international standards designed to meet the needs of China's socialist market economy.
- These standards are incorporated into law.
- The accrual basis, the concept of consistency, the matching of revenue and expenses and the quality of objectivity are all required by the standards.

#### *Assets*

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- The use of historical cost for assets is specified and a clear distinction between revenue expenditures and capital expenditures must be made.
- Assets should be classified into current and noncurrent categories.
- Inventories may be valued using most conventional methods, including LIFO.
- Fixed assets may be depreciated using the straight-line or the activity method. If the enterprise receives approval, accelerated depreciation may be used.
- Intangible assets, including goodwill, are recognized and are to be amortized over the period benefited.

#### *Liabilities*

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- Liabilities should be classified as current or long-term.

#### *Equity*

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- Equity is classified into invested capital, capital reserve, surplus reserve, and undistributed profit. Invested capital represents the face value of stock issued and government investment. Capital reserve represents stock premium, asset revaluation increments, donated capital, etc. Surplus reserve is analogous to appropriated retained earnings, and undistributed profit is analogous to unappropriated retained earnings.

#### *Revenue/Expense/Profit*

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- Revenues are determined using the accrual basis including the completed contract and percentage-of-completion methods for long-term projects.
- Expenses are determined using the accrual basis and actual costs incurred. Enterprises using standard or estimated costs must adjust variances to actual at the end of the current month.
- The plan for distribution of profits must be shown in the income statement or the notes to the financial statements.

#### *Financial Reporting and Disclosure*

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- Required reports consist of a balance sheet, an income statement, a statement of changes in financial position (or cash flow statement), supporting schedules, notes, and explanatory statements.
- Comparative financial statements are required.
- Consolidated financial statements are required in cases of 50% or more ownership except for enterprises not suitable for consolidation.
- Notes to financial statements must disclose accounting methods adopted, changes in accounting methods, descriptions of unusual items, and other details and explanations.

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*Source:* Gary M. Winkle, H. Fenwick Huss, and Chen Xi-Zhu, "Accounting Standards in the People's Republic of China: Responding to Economics Reforms," *Accounting Horizons* (September 1994): 54.

**EXHIBIT 4-4 Accounting Systems in China*****Industry-Based Systems***

- Industrial Enterprise Accounting System
- Commercial Enterprise Accounting System
- Transportation Enterprise Accounting System
- Transportation (Railways) Enterprise Accounting System
- Transportation (Aviation) Enterprise Accounting System
- Transportation (Postal Services and Telecommunication) Enterprise Accounting System
- Hospitality Enterprise Accounting System
- Construction Enterprise Accounting System
- Real Estate Development Enterprise Accounting System
- Agricultural Enterprise Accounting System
- Financial Institution Accounting System
- Insurance Enterprise Accounting System
- Foreign Economic Cooperative Enterprise Accounting system

***Ownership-Based Systems***

- Foreign Investment Enterprise Accounting System
- Limited Stock Companies Accounting System

*Source:* Yin Chen, Peter Jubb, and Alfred Tan, "Problems of Accounting Reform in the People's Republic of China," *The International Journal of Accounting* 32, no. 2 (1997) 142. Updated by authors.

## Financial Reporting<sup>18</sup>

The accounting period is required to be the calendar year. Financial statements consist of:

1. Balance sheet
2. Income statement
3. Cash flow statement
4. Notes
5. Supporting schedules

The notes include a statement of accounting policies. As applicable, they discuss such matters as important events and related party transactions. Additionally, the notes disclose changes in capital structure, appropriations of profits, and principal taxes paid. The supporting schedules provide additional details supporting financial statement items. Financial statements must be comparative, in Chinese, and expressed in the Chinese currency, the renminbi. They are required quarterly and annually; the annual financial statements must be audited by a Chinese CPA. Consolidated financial statements are required and the annual statements must provide an overview of the enterprise's financial condition. Chinese listed companies issuing shares to foreign investors

<sup>18</sup>Different regulations apply to different types of companies such as state-owned enterprises, collectives, joint stock limited companies, and enterprises with foreign investment. As discussed earlier, China's accounting standards are evolving with the aim of developing a harmonized set of standards for all enterprises. Our discussion of financial reporting requirements and practices is limited to limited-liability companies and those with foreign investors.

(so-called B-shares) must put English and Chinese language versions of their annual reports on the CSRC Web site.<sup>19</sup>

### Accounting Measurements

The purchase method must be used to account for business combinations, and goodwill is written off over the period benefited. The equity method is used when the ownership of another enterprise exceeds 20 percent. When ownership exceeds 50 percent, the accounts of the subsidiary are consolidated. For overseas subsidiaries, the balance sheet is translated at the year-end exchange rate, the income statement is translated at the average-for-the-year exchange rate, and any translation difference is shown as a reserve in equity.

Although accounting measurements in China are generally aligned with international accounting practice, they differ somewhat in their emphasis. Compared to international accounting practice, reliability is stressed over relevance, historical cost is more strictly adhered to, and the principle of conservatism is practiced on a more limited basis. Tax law still has some influence, though it is declining.

Historical cost is the basis for valuing tangible assets. They are depreciated over their expected useful lives, normally on a straight-line basis. (Tax law requires straight-line depreciation and is referred to in specifying the useful lives of assets and salvage values.) FIFO, average, and LIFO are acceptable costing methods, and inventory is written down for price declines and obsolescence. Acquired intangibles are also recorded at cost and amortized over the periods benefited. Because land and much of the industrial property in China is owned by the state, companies that acquire the right to use land and industrial property rights show them as intangibles. Assets are revalued when a change in ownership takes place, such as when a state-owned enterprise is privatized. Certified asset assessment firms or CPA firms determine these valuations.

Costs associated with research and development can be capitalized in some circumstances. Finance leases are capitalized and deferred taxes are provided for. Contingent obligations are provided for when they are both probable and a reliable estimate can be made of their amount.

## Taiwan

Taiwan was originally known in the West as Formosa, a name meaning “beautiful island,” given to it by Portuguese sailors in the fifteenth century. Taiwan has been predominantly Chinese since becoming a protectorate of the Chinese Empire in 1206. In 1887 Taiwan became a province of China, but from 1895 until 1945 it was a Japanese colony. At the end of World War II, Taiwan reverted to China.

The constitution of the Republic of China was written in 1946. In 1949, defeated by the Communists, the remnants of the Republic of China, led by Chiang Kai-shek, fled to Taiwan and established a provisional government there. Today, Taiwan is officially known as the Republic of China, while mainland China is known as the People’s Republic of China. Each maintains claims over the other, which fosters a delicate and complex relationship between them.

Over four decades, Taiwan transformed itself from an underdeveloped, agricultural island to an economic power that is a leading producer of high-technology goods. This

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<sup>19</sup><http://www.csrc.gov.cn/>

outstanding growth has been based on the success of its manufactured products in export markets. Taiwan's economy has developed in three distinct phases since 1949. During the 1950s, agriculture and import-substituting industries dominated economic growth. The second phase began in the 1960s and focused on export expansion, propelled by the assembly of imported component parts for consumer goods and low technology, light industry. The most recent phase involves high technology and capital intensive industries. Early growth was fueled by substantial economic aid from the United States. Today Taiwan is an aid donor and major investor, especially in Asia. (In fact, Taiwan has significant investments in mainland China.<sup>20</sup>)

Taiwan has a dynamic capitalist economy with gradually decreasing government guidance of investment and foreign trade. Small, family-owned businesses are the basis of the economy.<sup>21</sup> Certain strategic industries, such as military goods, petroleum refining, and public utilities were once reserved for the state, and the government had ownership positions in banks and a number of industrial firms, especially those that required large amounts of capital. However, the state is now privatizing its ownership in these firms.

Taiwan can be said to have a credit-based financial system along the lines of Germany and Japan (described in Chapter 3) rather than a capital market-based system. The Taiwan Stock Exchange opened in 1962 and has grown steadily since the second half of the 1980s. Improving the capital market is an important priority of the Taiwanese government. Although most Taiwanese companies are small and closely held by controlling families, the Taiwan Stock Exchange has the largest market capitalization of any emerging stock market.<sup>22</sup>

Today the United States is Taiwan's largest trading partner, taking 25 percent of its exports and supplying 17 percent of its imports.<sup>23</sup> The influence of the United States on accounting in Taiwan is also strong. Financial reporting, auditing, and other aspects of accounting are similar to those found in the United States.

### Accounting Regulation and Enforcement

The Commercial Accounting Law, as amended in 1987, regulates accounting records and financial statements in Taiwan. It applies to enterprises established under the Business Regulation and Company Laws, except for small partnerships or sole proprietors. The law sets forth the accounting records that must be kept and lays out broad provisions for the financial statements, notes, and other disclosures. Requirements include accrual accounting and a calendar year fiscal period. The law also emphasizes that financial accounting is distinct from tax accounting.<sup>24</sup>

Accounting standards are set by the Financial Accounting Standards Committee (FASC) of the Accounting Research and Development Foundation (ARDF). The

<sup>20</sup>Since 1990, Taiwan has invested \$24 billion there, and there are commitments for an additional \$20 billion. See "Taiwan's Tightrope," *BusinessWeek Online*, March 20, 2000.

<sup>21</sup>There is one company for every 18 people, the highest density in the world. Small to medium-sized enterprises make up 98.5 percent of Taiwan's companies, 75 to 80 percent of all employment, and 47 percent of the total economy. See "In Praise of Paranoia: A Survey of Taiwan," *The Economist* (November 7, 1998): 9.

<sup>22</sup>The Economist, *Pocket World in Figures: 2001 Edition*, London: The Economist, 2000, 58.

<sup>23</sup>U.S. Department of State, "Background Notes: Taiwan," October 2000, p. 12.

<sup>24</sup>S. T. Chiang, "Taiwan," chap. 4 in *Financial Reporting in the West Pacific Rim*, T. E. Cooke and R. H. Parker, eds., New York: Routledge, 1994, 138.

ARDF, modeled on the Financial Accounting Foundation in the United States, was established in 1984 to upgrade the level of accounting study, advance the development of accounting and auditing standards, and help industrial and commercial enterprises improve their accounting systems. It is an endowed private institution, but is supervised by the Ministry of Finance. Its board of directors includes government officials, practicing CPAs, academics, representatives of business, and officials of the Taiwan Securities and Exchange Commission. The FASC, also established in 1984, follows a due process procedure much like the U.S. Financial Accounting Standards Board. Before it issues a standard, the FASC prepares an exposure draft, solicits opinions from parties concerned, holds public hearings if necessary, and sometimes prepares revised exposure drafts. Another committee of the ARDF, the Auditing Standards Committee, issues auditing standards, following a process much like the FASC. Accounting and auditing standards are based on national requirements, with reference to both U.S. GAAP and IAS. Companies listed on the Taiwan Stock Exchange face additional disclosure requirements of the Securities and Exchange Commission, an agency within the Ministry of Finance.<sup>25</sup>

The National Federation of CPA Associations (NFCPAA), an organization mandated by the CPA Law of Taiwan, represents the accounting profession. Practicing CPAs in Taiwan belong to one of the provincial or municipal CPA associations, which in turn make up the NFCPAA. The NFCPAA coordinates with government regulatory authorities on matters of concern to the profession, issues statements on professional ethics, and provides continuing professional education. Before the establishment of the ARDF, the NFCPAA also issued accounting and auditing standards.<sup>26</sup> The examination and licensing of CPAs is a government responsibility. The exam is administered by the Ministry of Examinations and CPA certificates are issued by the Ministry of Finance.<sup>27</sup>

### Financial Reporting

The Commercial Accounting Law requires the following financial statements:

1. Balance sheet
2. Income statement
3. Statement of changes in owners' equity
4. Statement of cash flows
5. Notes

The notes must disclose the following information:

- Summary of significant accounting policies
- Reasons for changes in accounting policies and their effect on the financial statements

<sup>25</sup>Young H. Chang, "Taiwan's Accounting Profession: A Response to National Economic Growth," *The International Journal of Accounting* 27, no. 1 (1992): 63–67.

<sup>26</sup>The NFCPAA was founded in 1946 on mainland China in the city of Nanking, and moved with the Nationalist government when it moved to Taiwan in 1949. In the 1950s, a number of American CPAs, working with the U.S. Agency for International Development, assisted in training Taiwanese government accounting personnel. American accounting textbooks are used most often for accounting education in Taiwan, so most CPAs are oriented toward U.S. standards. See S. T. Chiang, "Taiwan," chap. 4 in *Financial Reporting in the West Pacific Rim*, T. E. Cooke and R. H. Parker, eds., New York: Routledge, 1994, 140–141.

<sup>27</sup>Young H. Chang, "Taiwan's Accounting Profession: A Response to National Economic Growth," *The International Journal of Accounting* 27, no. 1 (1992): p. 66.

- Creditors' rights to specific assets
- Material commitments and contingent liabilities
- Limitations on the distribution of profits
- Significant events relating to owners' equity
- Significant subsequent events
- Other items that require explanation to avoid misleading impressions or that require clarification to assist in presenting the financial statements fairly.<sup>28</sup>

Financial statements must be comparative and the fiscal period must be the calendar year. Financial statements audited by CPAs are required for publicly held companies and for nonpublic companies with capital in excess of NT\$30 million or outstanding bank loans of more than NT\$30 million. Banks, insurance companies, and securities firms must have their financial statements audited by CPAs.<sup>29</sup> State-run government enterprises are audited by government auditors. Companies listed on the stock exchange must also provide audited semiannual financial statements, quarterly financial statements reviewed by a CPA, and a monthly sales report.<sup>30</sup>

### Accounting Measurements

Consolidated financial statements are required when a company controls another entity; normally more than 50 percent of ownership. The purchase method is required for business combinations; the pooling of interests method is not used. Under the purchase method, assets are transferred on the basis of book values, though adjustments can be made for higher market values. Goodwill is normally capitalized and amortized over 20 years or less. The equity method is used when there is 20 percent or more ownership in another company. Foreign currency translation is consistent with International Accounting Standard 21 and the U.S. SFAS No. 52. The balance sheets of foreign entities that are independent of the parent are translated at the year-end rate and the income statement is translated at the average rate. Translation adjustments are charged to shareholders' equity. The temporal method is used for nonautonomous subsidiaries and the translation adjustment is charged to income.

Fixed assets, including land and natural resources, and intangible assets may be revalued. The government announces values for land each year, and enterprises are allowed to restate land values (annually) in accordance with the government-announced value. Other assets may be revalued in accordance with a government price index when prices rise by more than 25 percent since purchase or previous revaluation. Capital reserve accounts are credited when assets are revalued. Depreciation and amortization are calculated on the basis of estimated useful lives. The method used does not have to conform to the tax law. Intangible assets are amortized over a maximum period of 20 years. Depreciation and amortization of revalued assets are based on their carrying values after revaluation.

<sup>28</sup>Ernst & Young, *Doing Business in Taiwan*, New York: Ernst & Young International, 1994, 66–67.

<sup>29</sup>Publicly held companies submit their audited financial statements to the Securities and Exchange Commission and publish them in a daily newspaper. Companies with capital in excess of NT\$30 million submit theirs to the Ministry of Economic Affairs, while companies with bank loans of more than \$30 million submit their statements to the lending banks. Banks, insurance companies, and securities firms submit their financial statements to the Securities and Exchange Commission.

<sup>30</sup>Price Waterhouse, *Doing Business in Taiwan*, New York: Price Waterhouse World Firm Services BV, 1996, 100.

Inventory is stated at the lower of cost or market; FIFO, LIFO, and average are all acceptable cost flow assumptions. As with depreciation, books need not conform to tax law. Research and development costs are charged to expense when incurred. Accounting for leases, contingencies, and deferred taxes are consistent with U.S. and international approaches. Thus, finance (called *capital*) leases are capitalized and contingent losses are accrued when they are both probable and subject to a reasonable estimate. Interperiod tax allocation is required if timing differences exist; thus, deferred taxes are accrued. Taiwanese companies must also set up a legal reserve in shareholders' equity: Ten percent of net income is appropriated each year until the reserve equals the total authorized capital stock of the company.

## Mexico

Before the Spanish conquest in the 1500s, Mexico was home to several highly advanced cultures, including the Olmecs, Mayas, Toltecs, and Aztecs. Hernando Cortés conquered Mexico in 1521 and founded a Spanish colony that lasted for nearly 300 years. Mexico declared independence in 1810 and an 1821 treaty recognized Mexican independence from Spain. Except for 30 years of internal peace under General Porfirio Díaz (1877 to 1880 and 1884 to 1911), Mexico experienced political and military strife until 1929, when what is now known as the Institutional Revolutionary Party (PRI) was formed. The PRI controlled Mexico's government continuously for 70 years. The 2000 presidential election was won by the National Action Party (PAN), a center-right opposition party, thus ending the supremacy of the PRI in Mexican politics.

Mexico is the most populous Spanish-speaking country in the world and the second most populous country in Latin America (after Portuguese-speaking Brazil).<sup>31</sup> Mexico has a largely free market economy: government-owned or controlled companies dominate petroleum and public utilities, but private enterprise dominates manufacturing, construction, mining, entertainment, and the service industries. In recent years, the government has also been privatizing its holdings in nonstrategic industries. Like most of Latin America, a decade of liberal reforms has helped reduce inflation, increase the rate of economic growth, and deliver healthier economic fundamentals.<sup>32</sup> Reforms include dismantling protectionist trade barriers, opening up to foreign investment, and signing regional trade agreements. The most important agreement for Mexico is the North American Free Trade Agreement (NAFTA), signed with Canada and the United States in 1994. The United States accounts for three-quarters of Mexico's imports, more than 80 percent of Mexico's exports, and 60 percent of all direct foreign investment.<sup>33</sup>

Family-controlled conglomerates dominate Mexico's private sector and, by world standards, are relatively small.<sup>34</sup> Although Mexico's stock market is the second largest in Latin America, it is still relatively small by international standards, as firms prefer to

<sup>31</sup>The capital, Mexico City, is the second most populous city in the world.

<sup>32</sup>This general trend still holds even though Mexico had a recession in 1995 when economic activity shrank about 7 percent following the 1994 peso devaluation. The economy has since recovered (more briskly than anticipated) with average annual growth over 5 percent.

<sup>33</sup>The Economist, *Pocket World in Figures: 2001 Edition*, London: The Economist, 2000, 165; U.S. Department of Commerce, "Mexico Country Commercial Guide FY2001," chap. 10 ([www2.usatrade.gov](http://www2.usatrade.gov)).

<sup>34</sup>The Economist notes an interesting paradox. "Capitalism has a much longer history in Latin America than in many parts of Asia. Yet whereas the largest Asian firms have grown swiftly to become household

raise capital through debt rather than equity. This is changing, however, and more and more Mexican firms are entering U.S. capital markets.

Given the dominance of family-controlled enterprises, Mexican companies traditionally guarded their information and were secretive in their financial reporting. This too is changing. Another significant feature of Mexican accounting is the use of comprehensive general price level accounting as a measurement basis.

The U.S. influence on Mexico's economy extends to accounting. "[M]any of the early leaders of the Mexican profession grew up on 'American accounting'"<sup>35</sup> and U.S. textbooks and professional literature (either in the original English or translated into Spanish) are used extensively in the education of accountants and as guidance on accounting issues. NAFTA accelerated a trend toward closer cooperation between professional accounting organizations in Mexico, Canada, and the United States. Today, the accounting standard-setting bodies in these three countries<sup>36</sup> are committed to a program of harmonization and are attempting to work in concert wherever possible. As a founding member of the International Accounting Standards Committee (now International Accounting Standards Board), Mexico is also committed to harmonization with International Accounting Standards.

### Accounting Regulation and Enforcement

The Mexican Commercial Code and income tax laws contain requirements for keeping certain summary accounting records and preparing financial statements, but their influence on financial reporting is generally minimal. The Mexican Institute of Public Accountants (*Instituto Mexicano de Contadores Públicos*) issues accounting and auditing standards in Mexico. Accounting standards are developed by the Institute's Accounting Principles Commission; auditing standards are the responsibility of its Auditing Standards and Procedures Commission. The institute, a federation of state and other local associations of registered public accountants, is an independent nongovernmental professional association representing the overwhelming majority of public accountants. The Mexican accounting profession is mature, well organized, and highly regarded by the business community.

Despite a legal system based on civil law, accounting standard setting in Mexico takes a British-American, or Anglo-Saxon, approach rather than a Continental European one. The standard-setting process is well developed. Before standards are finalized, exposure drafts of proposed standards are issued for review and public comment. Accounting standards are recognized as authoritative by the government, in particular, by the National Banking and Securities Commission, which regulates the Mexican Stock Exchange. Mexican accounting principles do not distinguish between large and small companies, and so are applicable to all business entities. In some cases the National Banking and Securities Commission issues rules for listed companies, which generally limit certain options in generally accepted accounting principles.

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names across the world, their Latin American counterparts have remained almost unknown outside their own region, or even their own country." (p. 7) See *The Economist*, "Back on the Pitch: A Survey of Business in Latin America" (December 6, 1997): 1-27.

<sup>35</sup>Stephen A. Zeff, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends*, Champaign, IL: Stipes Publishing, 1971, 96-97.

<sup>36</sup>The Instituto Mexicano de Contadores Públicos, Canadian Institute of Chartered Accountants, and the Financial Accounting Standards Board, respectively.

Requirements for preparing financial statements and having them audited vary by type and size of company. All companies incorporated under Mexican law (*sociedades anónimas*) must appoint at least one statutory auditor to report to the shareholders on the annual financial statements. Statutory auditors do not have to be public accountants, but when a firm uses independent auditors, a member of the auditing firm frequently acts as statutory auditor. Companies or consolidated groups that meet certain size criteria must file a tax-compliance audit report every year with the Federal Tax Audit Department of the Ministry of Finance. The report consists of audited financial statements, additional schedules, and a statement by the auditor that no irregularities were observed regarding compliance with tax laws. This audit must be done by a Mexican public accountant. Finally, companies listed on the Mexican Stock Exchange must submit annual consolidated financial statements, audited by a Mexican public accountant, to the exchange and to the National Banking and Securities Commission.

### Financial Reporting

Since 1990 the fiscal year of Mexican companies must coincide with the calendar year. Comparative consolidated financial statements must be prepared, consisting of:

1. Balance sheet
2. Income statement
3. Statement of changes in stockholders' equity
4. Statement of changes in financial position
5. Notes

Financial statements must be adjusted for inflation. The effects of the adjustment are shown in the statement of changes in stockholders' equity. The format of the statement of changes in financial position is similar to the statement of cash flows and is divided into operating, investing, and financing activities. However, because it is also prepared in constant pesos, the resulting "cash flows" do not represent cash flows as understood under historical cost accounting.

Notes are an integral part of the financial statements (covered by the auditor's report) and include the following:

- Accounting policies of the company
- Material contingencies
- Commitments for substantial purchases of assets or under lease contracts
- Details of long-term debt and foreign currency exposure
- Limitations on dividends
- Guarantees
- Employees' pension plans
- Transactions with related parties
- Income taxes.<sup>37</sup>

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<sup>37</sup>Price Waterhouse, *Doing Business in Mexico*, New York: Price Waterhouse World Firm Services BV, 1995, 125.

### Accounting Measurements<sup>38</sup>

Consolidated financial statements are prepared when a parent company controls another company. Control is indicated by the ability to determine operating and financial policies of a company. Control normally exists when more than 50 percent of a company's common stock is owned, but it can be obtained in other ways, including the ability to appoint management or a majority of the board of directors. The equity method is used when there is influence but not control, normally meaning an ownership level between 10 and 50 percent. Mexico has adopted International Accounting Standard No. 21 on foreign currency translation.

Both the purchase and the pooling of interests methods of accounting for business combinations may be used, depending on the circumstances. If a majority of the shareholders of the acquired company do not retain an interest in the continuing business, the purchase method is used; if they do, pooling is used. Goodwill is the excess of purchase price over the current value of the net assets acquired. It is amortized to income over the expected benefit period, which is limited to 20 years.

General price level accounting is used in Mexico. The historical costs of nonmonetary assets are restated in pesos of current purchasing power by applying factors derived from the National Consumer Price Index (NCPI). (Before 1996, current replacement cost based on appraisals or specific price indices was also acceptable. This approach was eliminated because it was viewed as less reliable and less in line with international standards based on historical cost.) The components of stockholders' equity are also restated using the NCPI. The gain or loss from holding monetary assets and liabilities is included in current period income, but the effects of other restatements are in stockholders' equity. Cost of sales and depreciation expense are expressed in constant pesos on the income statement, consistent with the treatment of inventory and fixed assets.

Research and development is expensed as incurred. Leases are classified as financing or operating. Financing leases—those transferring substantially all the benefits and risks of ownership of the asset—are capitalized, while rents from operating leases are expensed on the income statement. Contingent losses are accrued when they are likely and measurable. General contingency reserves are not acceptable under Mexican GAAP. The partial liability method is used for deferred taxes: They are only provided for timing differences whose reversal is reasonably assured within a definite period of time (generally 3 to 5 years) and will not be replaced by other timing differences of a similar nature and amount. Thus, they are normally not computed for recurring timing differences such as those arising from differences between tax and accounting depreciation. The costs of employee pensions, seniority premiums,<sup>39</sup> and termination pay are accrued currently when they can be reasonably estimated based on actuarial calculations. Statutory (legal) reserves are created by allocating 5 percent of income each year until the reserve equals 20 percent of the value of the outstanding capital stock.

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<sup>38</sup>As noted earlier, the Mexican Institute of Public Accountants looks to the United States as well as the International Accounting Standards Board in developing generally accepted accounting principles. While the standards do not cover all areas, overall practice is fairness oriented.

<sup>39</sup>Seniority premiums are compensation amounts paid at the termination of employment based on how long the employee has worked. Generally, employees who voluntarily retire must work at least 15 years, but there is no minimum number years for other types of termination, such as redundancy layoffs, or if an employee dies.

**EXHIBIT 4-5 Summary of Significant Accounting Practices**

	<i>Czech Republic</i>	<i>China</i>	<i>Taiwan</i>	<i>Mexico</i>
1. Consolidated financial statements	Required	Required	Required	Required
2. Statement of cash flows	In notes	Required	Required	Required
3. Business combinations: purchase or pooling	Purchase	Purchase	Purchase	Both
4. Goodwill	Immediate write-off or capitalize & amortize; 5-year maximum	Capitalize & amortize	Capitalize & amortize; 20-year maximum	Capitalize & amortize; 20-year maximum
5. 20% to 50% owned affiliates	Equity method	Equity method	Equity method	Equity method <sup>a</sup>
6. Asset valuation	Historical cost	Historical cost	Revaluation allowed	Constant purchasing power
7. Depreciation	Economic based	Economic based <sup>b</sup>	Economic based	Economic based
8. LIFO inventory valuation	Not used	Acceptable	Acceptable	Acceptable <sup>c</sup>
9. Finance leases	Not capitalized	No guidance	Capitalized	Capitalized
10. Deferred taxes	Accrued for depreciation differences only	No guidance	Accrued	Partial liability method

<sup>a</sup>When ownership exceeds 10%.

<sup>b</sup>With reference to tax law.

<sup>c</sup>But with inflation accounting, not used.

Exhibit 4-5 summarizes the significant accounting practices in the four countries surveyed in this chapter.

**Discussion Questions**

1. Level of education affects a nation's accounting development (see Chapter 2). One measure of education level is the literacy rate. *Pocket World in Figures 2001* (London: The Economist, 2000) gives the following literacy rates: China, 83 percent; Czech Republic, 99 percent; Mexico, 90 percent; and Taiwan, 94 percent. What do these literacy rates suggest about accounting in these four countries?
2. Exhibit 4-2 shows that 29 Mexican companies are listed on the New York Stock Exchange (as of December 2000). The 29 listings occurred as follows: 1991, 2; 1992, 3; 1993, 7; 1994, 9; 1995, 0; 1996, 2; 1997, 2; 1998, 2; 1999, 1; 2000, 1. What does the pattern of listings between 1991 and 2000 suggest?
3. The chapter states that accounting and auditing standard setting in Taiwan is patterned after that in the United States. What are the similarities and differences in standard setting in the two nations?

4. Does the development of accounting lead or lag behind the development of a nation's economy? Cite evidence from this chapter to support your answer.
5. Both China and the Czech Republic are restructuring their economies from central planning to more of a market orientation. What are the similarities and differences in the approaches each country is taking in embracing market reforms?
6. Even before Hong Kong reverted to China in 1997, China was well on the way toward developing accounting standards compatible with those of the International Accounting Standards Committee. How will the return of Hong Kong likely affect China's accounting standards?
7. What are the important features of accounting and financial reporting that are necessary to develop an efficient stock market with fair trading? How likely is it that the countries in this chapter will develop such a stock market? Why do you think so?
8. What is the role of tax legislation on financial accounting practices in each of the four countries treated in this chapter?
9. The Czech Republic is developing a body of accounting requirements consistent with European Union directives. What evidence is there that Czech accounting requirements comply with these directives? (Hint: you may want to refer to the discussion of the European Union in Chapter 8.)
10. China's aim is to develop accounting standards that are harmonized with international practices. What examples are there that Chinese accounting standards are consistent with "world class" practices?
11. What evidence is there that accounting practices in Taiwan are similar to those found in the United States?
12. Mexican companies that list their shares on the New York Stock Exchange are required by the U.S. Securities and Exchange Commission to reconcile net income and stockholders' equity from Mexican to U.S. GAAP. What are likely to be the most significant reconciliation items?

## Exercises

1. This chapter provides synopses of national accounting practice systems in four emerging economies.  
**Required:** For each country, list:
  - a. The name of the national financial accounting standard-setting board or agency.
  - b. The name of the agency, institute, or other organization charged with supervising and enforcing financial accounting standards.
2. The International Federation of Accountants (IFAC) is a worldwide organization of professional accounting bodies. IFAC's website ([www.ifac.org](http://www.ifac.org)) has links to accounting bodies around the world.  
**Required:** Visit IFAC's Web site. List the accounting organizations discussed in this chapter that are linked to IFAC's Web site.
3. Reread Chapter 4 and its discussion questions.  
**Required:**
  - a. As you go through this material, prepare a list of eight expressions, terms, or short phrases unfamiliar or unusual in your home country.
  - b. Write a concise definition or explanation of each item.
4. Analyze the four national accounting practice systems summarized in the chapter.

**Required:**

- a. For each of the four countries treated in the chapter, select the most important financial accounting practice or principle at variance with international norms.
  - b. For each selection you make, briefly state your reasons for including it on your list.
5. Refer to Exhibit 4-2.
- Required:** Discuss the factors that might explain the listing pattern observed in the table.
6. Several companies from the four countries treated in this chapter are listed on the New York Stock Exchange (NYSE), NASDAQ, and the London Stock Exchange.
- Required:** Go to the NYSE Web site ([www.nyse.com](http://www.nyse.com)). Identify the companies listed on the NYSE from each of the four countries treated in this chapter and indicate the year that each company became listed. Do the same for the NASDAQ ([www.nasdaq.com](http://www.nasdaq.com)) and the London Stock Exchange ([www.londonstockexchange.com](http://www.londonstockexchange.com)).
7. Chapter 2 discussed certain socioeconomic and institutional factors that affect accounting development. These were: (1) sources of finance, (2) legal system, (3) taxation, (4) political and economic ties, (5) inflation, (6) level of economic development, and (7) education level.
- Required:**
- a. Identify the factor that you think is the most important influence on accounting in each of the four countries treated in this chapter.
  - b. Explain the significance of this factor and why you think it is the most important one.
8. Refer to exercise 7.
- Required:**
- a. Identify the factor that you think is the least important influence on accounting in each of the four countries treated in this chapter.
  - b. Explain why you think it is the least important one.
9. Several companies from the four countries treated in this chapter refer to International Accounting Standards in their annual reports.
- Required:** Go to the Web site of the International Accounting Standards Committee ([www.iasc.org.uk](http://www.iasc.org.uk)). Identify the companies from China, the Czech Republic, Mexico, and Taiwan that refer to International Accounting Standards.
10. The role of government in developing accounting and auditing standards varies in the four countries treated in this chapter.
- Required:** Compare the role of government in developing accounting and auditing standards in China, the Czech Republic, Mexico, and Taiwan.
11. Accounting standard setting in most countries involves a combination of private and public sector groups. The private sector includes the accounting profession and other groups affected by the financial reporting process, such as users and preparers of financial statements and labor. The public sector includes government agencies such as tax authorities, ministries responsible for commercial law, and securities commissions. The stock market is another potential influence.
- Required:** Complete a matrix indicating whether each of these groups significantly influences accounting standard setting in the four countries discussed in this chapter. List the groups across the top and the countries down the side; indicate the influence of each group with a yes or no.

12. The following are certain financial ratios used by analysts:
- *Liquidity*: current ratio; cash flow from operations to current liabilities
  - *Solvency*: debt to equity; debt to assets
  - *Profitability*: return on assets; return on equity

**Required:** Assume that you are comparing the financial ratios of companies from two countries discussed in this chapter. Discuss how the accounting practices identified in Exhibit 4-5 would affect your comparisons for each of the six ratios listed.

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## Case 4-1 Does Secrecy Pay?

### SIGN OF THE TIMES: TRANSPARENCY AWARDS

#### Prague: Czech Republic<sup>1</sup>

By Robert Patton

If the “ABN AMRO Signum Temporis Awards for disclosure” had been held in 1994, Seliko probably would not have walked off with a prize.

Back then, an analyst for Atlantik Financial Markets brokerage asked the managers of this Czech food producer to discuss their business plans. Sure, they said—for \$200 an hour.

Several weeks of the analyst’s phone calls finally wore down Seliko’s top brass, which eventually met with him free of charge.

Still, the episode is a particularly appalling example of an all-too-common problem: Czech managers are notoriously tight-fisted with company information.

Through events such as the bank’s Signum Temporis (“sign of the time”) awards for best corporate disclosure, planned for Feb. 27 at the Prague Stock Exchange (PSE) Ball, brokers are trying to persuade executives to be more open. Award officials say some Czech companies are finally realizing that to attract more investment, they must let investors know what they’re getting into.

But analysts say many Czech companies continue to frustrate investors’ attempts to obtain such information. Despite the progress made so far, regional rivals Poland and Hungary have left the Czechs in the dust.

Some Czech firms simply give out as little information as possible, analysts say, and others take months to release basic financial data. Still others fail to publicize results.

A company might release new financial data, “but unless you call them, you don’t know about it,” said ING Barings analyst Vojtech

Kraus. “They’ll just tell investors who happened to come see them that week.”

Some Czech companies, particularly large conglomerates, may have good intentions but simply aren’t experienced at quickly compiling and disseminating their financial data. Financial-industrial giant Skoda Plzen is good example of this, said Patria Finance analyst Ondrej Datka.

Leaving aside the shady managers with something to hide, many others simply don’t believe it’s important to keep investors informed.

Secretive companies often have managers with attitudes forged during the ’70s and ’80s, said Pavel Kohout, a portfolio manager at ING Investment Management. Under communism, secrecy—not transparency—was the watchword.

The conglomerate Chemapol is the quintessential example of a company run by old dogs who can’t or simply won’t learn new capitalist tricks. They’ve been “used to being opaque since communism,” Kohout said.

Coupon privatization did little to change such attitudes. Many managers find themselves in publicly traded companies against their will.

Many Czech companies “didn’t come to the stock market,” said Datka. “They found themselves on the stock market as a result of privatization.”

By contrast, many Polish and Hungarian firms have issued initial public offerings (IPOs) of stock and so are more concerned with investor satisfaction.

Analysts typically want a balance sheet, profit/loss statement, a cash-flow statement, and basic information about corporate outlook and goals. Legislation and PSE regulations help investors by forcing companies to divulge key financial data.

Every company with tradable securities must publish annual and semiannual reports and send them to the Finance Ministry and Czech Sta-

<sup>1</sup>*The Prague Post* (February 25, 1998), [www.praguepost.cz](http://www.praguepost.cz)

tistical Office. And companies whose stock is traded on the PSE's primary and secondary markets must also release quarterly financial reports.

But the PSE doesn't enforce its deadlines strictly enough, said Datka. And some companies submit financial data to the PSE that is timely but "unconsolidated"—that is, it does not incorporate data for subsidiaries.

That's not very useful, because in many cases "unconsolidated data don't mean anything," Datka said, and consolidated figures often don't appear until months later.

The semiannual reports to the Ministry of Finance, too, often linger "somewhere on the table of some clerk in the Finance Ministry" for as long as two months before becoming available to the public, complained Milon Miller, project manager for the Prague branch of Consultants PlanEcon.

Investors hope capital-markets reform will stimulate foreign strategic investment into Czech companies and help make them more transparent. Strategic investors are more likely to discipline managers, said Central Europe Privatization Fund President Howard Golden.

Under such owners, secretive executives "would be more transparent or they would be out," Golden said.

The trend may have already begun. Komerční Banka, SPT Telecom and tram-maker CKD have become more generous, analysts say. In many cases, such firms are providing more information partly to attract investors.

Several analysts said the improvement is steady but incremental. Golden went so far as to say that Czech firms are "light-years ahead of where they were two to three years ago."

Is Seliko riding this wave of increasing transparency? Well, sort of.

Now that it's partly owned by the Olpran Group, Seliko wouldn't try to charge for information, Olpran spokeswoman Marie Logrova insisted.

"We wouldn't go that far, but the information we'd give out probably wouldn't be that precise," she said. "We'd have to check with the other shareholders of Seliko before providing more specific information."

And who are Seliko's other shareholders? "I'm not authorized to answer that."

## REQUIRED

1. Describe the financial reporting practices of Czech companies, as characterized in the newspaper article.
2. What are the likely causes of these practices?
3. How do these practices compare to the reporting requirements identified in the chapter?
4. What are the consequences of these practices for investors, the reporting companies, and the Prague Stock Exchange?

## Case 4-2 After NAFTA

In 1992 the accounting standard-setting bodies in Canada, Mexico, and the United States (the Canadian Institute of Chartered Accountants, Instituto Mexicano de Contadores Públicos, and Financial Accounting Standards Board, respectively) did a joint study of the similarities and differences in the accounting standards of

the three countries, the underlying concepts, and the standard-setting processes. The study was a first step in spurring future cooperation for progress in accounting harmonization among the three countries. The following are certain findings taken from the joint study, published in 1994.

## FINANCIAL REPORTING IN NORTH AMERICA<sup>2</sup>

A nation's capital markets bring together those who are seeking funds and those who have funds to lend or invest. Those who have funds to lend or invest, including individuals, investment companies, insurance companies, pension funds, banks and other thrift institutions, governments, and business corporations try to balance risks and returns.

A nation's capital markets involve both domestic and foreign consumers and providers of capital. Some capital markets are public and highly competitive, and some are private and relatively noncompetitive. In all cases, to balance risks and returns, suppliers of capital need relevant and reliable financial information about companies that are seeking capital. For that reason, accounting standards are important for capital markets.

Differences in the capital markets and economic conditions between Canada, Mexico, and the U.S. may have contributed to differences in the scope and specificity of each country's accounting standards. . . .

Of the three countries, the U.S. has, by far, the largest public capital markets. Canada's capital markets, although smaller than those of the U.S., contain many of the same characteristics—a high degree of competition, large numbers of suppliers and consumers of capital, and a wide range of debt, equity and derivative securities. Moreover, the U.S. is Canada's largest trading partner and supplier of foreign capital. It is understandable, therefore, that U.S. and Canadian accounting standards are often parallel. . . .

In contrast to Canada and the U.S., Mexico's capital market is characterized by tight control by the majority shareholders of listed companies and significant, but decreasing, participation by the Mexican government. This may be one of the reasons why Mexico's accounting standards are less specific in certain circumstances.

Economic conditions also can affect accounting standards. One example is Mexico's adoption of inflation accounting. . . . Canada and the U.S. do not include inflation adjustments in financial statements. Both, however, allow financial disclosures adjusted for either specific price changes or general inflation as supplemental information.

Despite differences in their capital markets and economic conditions, all three countries currently are experiencing certain similar economic trends:

- Growing and substantial reliance on foreign sources of capital
- Broader ownership of companies
- Growing reliance on each other as major international trading partners
- Government policies that encourage or emphasize the need for price stability.

If those trends continue, the demands of financial statement users in all three countries will become increasingly similar—suggesting the need for greater comparability and improvement in their accounting standards.

### REQUIRED

1. Discuss the influence of capital market structures and economic conditions on accounting in Canada, Mexico, and the United States.
2. Based on your discussion in question 1., what features of accounting would you expect to find in these three countries? What accounting similarities and differences exist between Canada, Mexico, and the United States?
3. How likely is it that accounting in the NAFTA countries can be harmonized in the future? What factors are likely to promote such harmonization? What factors are likely to inhibit harmonization?

<sup>2</sup>Canadian Institute of Chartered Accountants, Instituto Mexicano de Contadores Públicos, and Financial Accounting Standards Board, *Financial Reporting in North America: Highlights of a Joint Study*, Norwalk:FASB, 1994, 3–5.