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Disharmony in international accounting standards setting: The Chinese approach to accounting for business combinations

C. Richard Baker^{a,b,*}, Yuri Biondi^c, Qjusheng Zhang^d^a School of Business, Adelphi University, Garden City, NY 11530, USA^b Professeur Affilié, Rouen Business School, France^c CNRS-Preg CRG-Ecole Polytechnique, 32 Boulevard Victor, Paris 75015, France^d School of Economics and Management, Beijing Jiaotong University, Beijing 100044, China

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ABSTRACT

The paper addresses two distinct aspects of disharmony in international accounting standards setting. The first aspect relates to the political economic context of financial accounting standards. This is illustrated by the Chinese standards setters' decision to allow the pooling of interests method of accounting for business combinations despite the prohibition of this method by both the FASB and the IASB. This decision by the Chinese standards setters appears to have been based on political economic factors related to the need for industrial reorganization in China rather than a desire to serve the needs of global capital markets. The second aspect of disharmony relates to the role played by differential understandings of the fundamental objectives of financial reporting in an international context. The IASB's goal of producing one set of global accounting standards to serve the needs of global capital markets has led to a reduction in the number of permissible accounting methods and a move towards the fair value accounting model. In particular, the IASB concluded that the acquisition method of accounting for business combinations should be the only method allowed for business combinations. In contrast, the Chinese standards setters have recognized the existence of both mergers and acquisitions, and in response they created two different methods of accounting for business combinations. Effectively, the Chinese standards setters developed an alternative approach to accounting for business combinations which challenges the IASB's goal of achieving international accounting convergence through the fair value model.

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1. Introduction

The Chinese approach to economic regulation since the 1980s has been directed towards two objectives: first, to integrate the Chinese economy into the global economic system, and, second, to foster economic development (Ezzamel et al., 2007; Biondi and Zhang, 2007). The Chinese accounting standard setting body (CASC) has often paid as much attention to political economic factors, such as increased production, employment and industrial reorganization, as it has to pressures from global capital market (Tsai, 2006). This approach differs from the stated objectives of the FASB and IASB, which place the information needs of capital markets at the core of everything.¹

* Corresponding author.

E-mail addresses: Baker3@adelphi.edu (C.R. Baker), yuri.biondi@free.fr (Y. Biondi), qs Zhang@bjtu.edu.cn (Q. Zhang).

¹ The joint FASB/IASB conceptual framework project states that: "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Capital providers are the primary users of financial reporting" (FASB, 2008).

The decision taken by the Chinese standards setters to allow the pooling of interests method constitutes an empirical example of the complex interaction between standards setting and its political economic context (Ezzamel et al., 2007). The Chinese decision also reveals the presence of disharmony in international accounting standards setting (De Lange and Howieson, 2006; Stolowy and Jeny-Cazavan, 2001). In their drive to achieve a single set of global accounting standards, the IASB, allied with the FASB, concluded that virtually all business combinations are acquisitions, and that there should be only one method of accounting for business combinations (i.e. the purchase or acquisition method). In contrast, the Chinese standards setters acknowledged the existence of business combinations that are not acquisitions (i.e. mergers), and they decided that mergers should not be accounted for by the acquisition method, but rather by the pooling of interests method instead. In essence, the capital markets orientation of the FASB and IASB blinded them to the existence of mergers, while the political economic context led the Chinese standards setters to recognize that mergers may actually be the most common types of business combination (Jackson and Miyajima, 2007).

Despite the proclamations of the IASB to the contrary, there has been considerable resistance to IASB standards from various directions, not only the Chinese (Ding et al., 2005; Stolowy and Jeny-Cazavan, 2001). For example, the French accounting standards setters rejected the non-amortization of acquisition goodwill in two decisions (Nos. 2005-9 and 2005-10).² The Japanese accounting standards setters manifested their dissent to IFRS 3 (Business Combinations) in several comment letters issued in 2001, 2003, and 2005. In 2006, the Chinese, Japanese and Korean standards setters joined together in an initiative which permits the continued use of pooling under certain circumstances (CASC, 2006). The Japanese standards setters authorized the pooling of interest method to be used in their national standards until December 2008, when they eliminated it “to respond to the assessment of equivalence with the European Union” (ASBJ, 2009, p. 2). In addition, Biondi and Zhang (2007) and Peng and Bewley (2009) have demonstrated that even though China has adopted fair value accounting as mandated by IFRS to some extent, substantial divergences between Chinese standards and IFRS exists in practice.

In this paper we argue that the actions of the various national accounting standards setters which allow or require accounting methods that differ from IFRS may be based on political economic factors rather than the needs of capital markets. In particular, the Chinese standards setters’ decision to authorize the pooling of interests method reflects the context of large scale industrial reorganization taking place in China (Xu and Uddin, 2008). The pooling method provides greater flexibility to banks and large industrial groups when reorganizing their operations without the need to refer to unreliable fair market value measures as required by IFRS3 (Pan, 2002; Huang et al., 2004; Busse von Colbe, 2004).

The remainder of this paper is organized as follows. The first section discusses the previous accounting literature dealing with disharmony in international accounting standards setting. The second section discusses the accounting standards setting process in China and provides an empirical case example of a business combination under common control. The third section discusses the Chinese decision from a political economic perspective. The fourth section discusses the pooling of interests method from an accounting theory perspective. The final section summarizes the main arguments of the paper and concludes.

2. Theoretical background and review of prior literature

This paper presents an argument that has been discussed previously in the accounting research literature. The argument is basically that:

- International Financial Reporting Standards (IFRS) are intended to serve the needs of international capital markets.
- In certain countries, accounting standards are also based on political economic factors, such as macro-economic policy making, economic development, and industrial reorganization.
- Certain international accounting standards may be rejected or modified by certain countries to meet the particular needs of the political economy in which the accounting standards operate.

The effort to establish a unique set of accounting standards to serve the needs of global capital markets, as well as satisfying the political economic needs of a particular nation state, is a daunting task. Rather than acknowledging the need of national standards setters to consider political economic factors when establishing accounting standards, the IASB has focused on the information needs of investors and creditors in global capital markets. This has led to a reduction in the number of allowable methods and a move towards the fair value accounting model in order to achieve global convergence of accounting standards, as well as counter efforts by a variety of political forces who seek greater control over the international accounting standards setting process.³

In this paper we argue that accounting and accountability are by no means unconcerned with political economic factors. Accounting standards form an integral part of the regulation of the economic system (Knorr Cetina and Preda, 2005). Accounting standards integrate the institutional structure that frames and shapes economic activity (Burchell et al., 1980). The consequences of one accounting method or another may induce different kinds of behavior and privilege certain stakeholders as compared with others (Hopwood, 1983). In a socio-economic world laden with bounded rationality and asymmetries of

² These decisions are primarily applicable to single companies and not listed groups.

³ See Norris (2009) for a discussion of political pressures brought to bear on the IASB to modify accounting for financial instruments.

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