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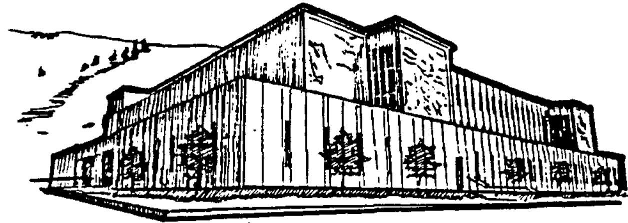

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University of
Montana

A comparative study of equity accounting in the United States and the United Kingdom from a generally accepted accounting practices viewpoint.

By

James Paul Luther

Presented in partial fulfillment of the requirements

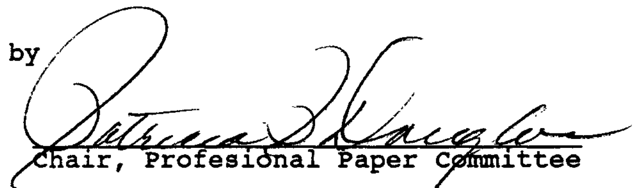
for the degree of

Master of Business Administration

University of Montana

April 1992

Approved by



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A comparative study of equity accounting in the United States and the United Kingdom from a generally accepted accounting principles viewpoint.

The many diverse systems of generally accepted accounting principles (GAAP) used to create financial statements around the globe yield financial statements of varying inter-company and inter-period comparability. This lack of global standards places a foreign investor, or any other user of foreign financial statements, in a rather disadvantageous position, as compared to a user of domestic financial statements. For effective communication of financial information to occur, financial statement users should be able to interpret the statements in question with adequate knowledge of the principles and procedures used to produce those financial statements.

Unfortunately, the broad issue of cross-cultural communication of financial accounting disclosures (or lack thereof) is far beyond the scope of this paper. Instead, this paper focuses on the relatively narrow issue of equity accounting and reporting in the United States (US) as compared to that in the United Kingdom (UK). The vast differences between US and UK accounting standards are exemplified by an actual extract from Beazer, P.L.C.'s 1990 financial statements contained in Exhibit 1 (following page) displaying a UK GAAP net income of £67.9 million and a US GAAP net income of £26.0 million for the 1990 fiscal year. The UK company's reported income suffers a 62 percent reduction in the translation to US GAAP. Beazer's total stockholders' equity under UK GAAP is £1,051.6 million, but only £590.6 million under US GAAP--a reduction of 44 percent.

The information in this paper is relevant to a wide variety of people. UK GAAP (or an accounting system closely related to UK GAAP) is practiced throughout the Commonwealth, including Hong Kong, India, Australia, and New Zealand. Anyone working, or investing, in the business sector in any of the commonwealth countries would need some knowledge of UK GAAP.

EXHIBIT 1 - Beazer, P.L.C.

ADDITIONAL FINANCIAL INFORMATION FOR US INVESTORS

Reconciliation of UK GAAP to US GAAP

Consolidated income statement	**1990 £m**	1989 £m	1988 £m
Net income after minority interests but before extraordinary items, under UK GAAP	**67.9**	92.6	75.6
Extraordinary items reclassified	**(29.0)**	(4.6)	0.6
Utilization of tax losses	-	(0.6)	(3.3)
Profit on sale and leaseback of a fixed asset	**(6.6)**	-	-
Amortization of goodwill	**(6.5)**	(5.8)	(4.7)
Reduction of depreciation arising from negative goodwill	**0.2**	0.2	0.2
Income from discontinued operations	-	(0.6)	(8.2)
Net income from continuing operations	**26.0**	81.2	60.2
Gain (loss) on disposal of discontinued operations	-	(0.6)	19.6
Income from discontinued operations	-	0.6	2.8
Extraordinary item - utilization of tax losses	-	-	0.2
Net income after minority interests and extraordinary items, under US GAAP	**26.0**	81.2	82.8

Net income per ordinary share

Undiluted			
Under UK GAAP	**22.76p**	31.85p	26.12p
Adjusted for US GAAP			
Continuing operations (note)	**7.76p**	27.71p	20.58p
Discontinued operations	-	0.22p	1.01p
Disposal of discontinued operations	-	(0.22p)	7.09p
Extraordinary items	-	-	0.07p
Net income	**7.76p**	27.71p	28.76p
Fully diluted			
Under UK GAAP	**21.51p**	29.90p	24.68p
Adjusted for US GAAP			
Continuing operations (note)	**7.82p**	26.10p	20.51p
Discontinued operations	-	0.19p	0.95p
Disposal of discontinued operations	-	(0.19p)	6.68p
Extraordinary items	-	-	0.07p
Net income	**7.82p**	26.10p	28.21p

Shareholders equity	**£m**	£m	£m
Shareholders' equity under UK GAAP	**1,051.6**	1,145.7	458.8
Goodwill	**128.6**	120.5	95.3
Negative goodwill	**(4.2)**	(4.2)	(3.6)
Deferred taxation	**(595.8)**	(663.8)	(33.5)
Reduction in depreciation arising from negative goodwill	**0.7**	0.5	0.3
Profit on sale and leaseback of a fixed asset	**(6.6)**	-	-
Property revaluation	**(0.1)**	(0.1)	(0.3)
Proposed dividends	**16.4**	16.2	13.9
Shareholders' equity under US GAAP	**590.6**	614.8	530.9

The UK is the single largest foreign investor in the US, with an investment balance (at historical cost) estimated at $108,055 million as of January 1, 1991. US investors also have substantial interests in the UK: an estimated historical cost investment balance of $64,983 million as of January 1, 1991. With the exception of Canada, the UK is the largest investment partner of the US. (United States Department of Commerce 1991) The cultural, linguistic and historical bonds between the US and the UK guarantee this close relationship will continue into the future.

PURPOSE

The purpose of this paper is to discern a logical pattern of thought in both UK and US accounting systems by providing a meaningful comparison of selected portions of GAAP used in the US and the UK. This paper presents a detailed analysis of accounting practices in the United States and the United Kingdom, and draws general conclusions based on that analysis. The stated goal of understanding current financial accounting thought was chosen due to the fast paced changes anticipated in UK accounting, resulting from the integration of the UK into the European community. Because of the numerous changes in UK GAAP anticipated in the near future, conceptual understanding of UK accounting thought should be far more beneficial than a knowledge of precise accounting standards at any one point in time. Based on a preliminary analysis, one would expect to find:

1. UK GAAP requires more disclosure than US GAAP, and,
2. UK GAAP allows individual companies far more latitude in choosing appropriate accounting methods than US GAAP.

METHODOLOGY

To assess the differences in accounting practices, the author compared US and UK GAAP as reflected in the respective accounting standards. In addition, the financial reporting of a selected group of companies was examined, although general compliance to accounting

standards was not assessed. Certain Exposure Drafts (ED) issued and outstanding at the time this paper was written have been included in this analysis. These exposure drafts are included in the hope that they will provide additional insight into current accounting thought in the respective countries; their inclusion should not be a judgment of the probability of these exposure drafts being incorporated into GAAP. The paper also contains a decided focus on accounting standards as required to be practiced by large public companies. Numerous exclusions from, and relaxations of, accounting standards exist for non-public or closely held entities, and these additional rules and regulations have been completely omitted from this analysis.

The emphasis upon the stockholders' equity section was chosen due to the author's belief that 1) all company activity is eventually reflected in the stockholders' equity section, and 2) many of the differences between US and UK GAAP are reflected in the stockholders' equity section. The presence of significant differences between US and UK GAAP in the stockholders' equity section is readily apparent to one with knowledge of US GAAP due to the number of unfamiliar account titles present on UK balance sheets.

The increased disclosure mentioned above is present on both the face of the financial statements and in the notes. The existence of the many reserve accounts present in the stockholders' equity section is an obvious example of additional disclosures on the face of the financial statements, while the complete disclosure of directors' background, compensation and other items is representative of a note disclosure requirement in the UK not found in the US.

Evidence of the greater latitude in the choice of accounting methods is also displayed in UK financial statements. The existence of the revaluation reserve implies the ability to revalue assets or liabilities and the presence of goodwill classified as both an asset and as a contra-equity balance point to diversity in accounting treatments. Nevertheless, to uncover the full extent of the greater latitude of the choice of accounting methods in the UK, one must look to the accounting standards.

US GAAP, as discussed in this paper, is based upon the 1990-1991 current text (June 30, 1990) of accounting standards issued by the Financial Accounting Standards Board (FASB). UK

GAAP, as discussed in this paper, is based upon UK accounting standards as of August 1, 1990. These standards are issued by the *new* Accounting Standards Board (ASB), but also include requirements legislated through government actions, principally the Companies Acts.

The selection and order of the topics presented in this paper follows the prescribed format of stockholders' equity accounts of UK financial statements (see Appendix 1). The paper begins with a description of accounting methods for capital stock and additional paid in capital, two accounts that are treated similarly in both the US and the UK. Following these two sections, the UK reserve accounts are analyzed in the following order: revaluation reserve, capital redemption reserve, goodwill reserve and merger reserve. These accounts are generally the result of accounting treatments not available to US companies. Following an analysis of selected elements of the retained earnings account, related party and directors' disclosures are contrasted.

UK - CALLED UP SHARE CAPITAL
US - COMMON AND PREFERRED STOCK

The accounting treatment for the issuance of shares of stock is largely standardized worldwide; and it is identical in all major respects in the US and the UK. The actual account titles used may include the terminology common stock, preferred stock, called up common shares, called up preferred shares, paid up common shares or a number of other minor variations; nonetheless, the titles are self-explanatory. The UK term "called up" is identical to the US term "issued and outstanding," and the UK term "allot" means to sell. The UK term "paid up" simply means that the stock subscription has been paid. For example, if the stock was purchased on subscription, the entire subscription receivable recorded at the time of sale has been received.

Both US and UK accounting standards require the balance in these accounts to reflect the total par (nominal, stated) value of the shares issued. Any excess consideration received over the par value is required to be recorded in the additional paid in capital or share premium

account. The par value of stock accounts may not be reduced for any reason other than the repurchase and/or permanent retirement of shares issued. (Chasteen, Flaherty and O'Conner 1989, 922-30)

Although the balance in the par value of stock account may not be reduced directly, the par value of stock has been constructively distributed in some states of the US. The constructive distribution has taken place by the creation of a negative balance in the retained earnings account (through distributions or negative earnings) large enough to produce a total negative stockholders' equity balance. The fact that some corporations have made distributions based on the fair value of the corporation, rather than the book value, has caused some authors to question the usefulness of current stockholders' equity accounting and disclosure. (Roberts, Samson, and Dugan 1990, 35-46)

Both the US (most states) and the UK have laws forbidding the sale of share capital at less than stated value, but some states in the US allow a stated value of zero, in which case the entire proceeds from the original sale of the stock are recorded in the capital stock account. A positive stated value is required in the entire UK, due to centralized regulation, whereas many securities laws are legislated at the state level in the US.

The Companies Acts require UK registered public companies to maintain a minimum authorized share capital of £50,000. An idiosyncrasy in UK law permits this minimum share capital to be denominated in any currency. This peculiarity of law exemplifies the lack of formal standardization of share capital accounting in the UK. Because no guidance on the treatment of foreign denominated stock issuances exists, UK firms have naturally interpreted the disclosure requirements in a variety of different ways. Some companies have maintained the foreign denominated share capital at a fixed sterling amount (most likely the original sale price converted to sterling at the date of original sale). Others have made an annual translation of the foreign denominated share capital into sterling at the date of each balance sheet presented at current exchange rates. Of the companies that have made an annual translation, some have recorded the net amount of annual change in the profit and loss accounts,

while others have included the annual difference directly in reserve accounts in the equity section of the balance sheet. (Davies, Paterson and O'Conner 1990, 589-90)

The following example, Exhibit 2, illustrates a variety of treatments and results possible depending on the accounting assumptions made by the company. Note that total stockholders' equity is identical in each case, but the translation difference changes character depending upon the treatment selected.

Exhibit 2
Currency Translation of Share Capital

A Taiwanese investor incorporates a new UK corporation, purchasing 20,000 shares of 10NT (New Taiwan Dollars) par value stock for 2,500,000NT on December 31, 1988, when the exchange rate was 1£ = 45NT. The journal entry to record the transaction would be:

	£	£
Cash (2,500,000 + 45)	55,556	
Share Capital (200,000 + 45)		4,444
Share Premium (2,300,000 + 45)		51,112
To record the sale of shares.		

Assuming no additional activity, on December 31, 1989, when the exchange rate was 1£ = 42NT, the balance sheet would display identical balances to those in the journal entry above for a company that did not perform an annual translation. In contrast, a company that performed a translation and included the translation change in the profit and loss account, the balance sheet would display the following balances:

Cash	55,556	
Profit and Loss [55,556 - (54,762 + 4,762)]		(3,968)
Share Capital (200,000 + 42)		4,762
Share Premium (2,300,000 + 42)		54,762
Total	55,556	55,556

While a company that performed an annual translation and included the translation in reserves would present the following balance sheet:

Cash	55,556	
Revaluation Reserves [55,556 - (54,762 + 4,762)]		(3,968)
Share Capital (200,000 + 42)		4,762
Share Premium (2,300,000 + 42)		54,762
Total	55,556	55,556

Although differences such as this exist, accounting for share capital is very similar in both countries, and a detailed explanation of the balances presented in the stated value of stock accounts, and the changes reflected in the current period, is required in both the US and the UK. This additional disclosure is generally presented in the notes to the financial statements, although many times some information is presented parenthetically on the face of the balance sheet. The notes will also provide information on the number of shares authorized, issued and outstanding at both the beginning and end of the accounting period for all classes of shares.

These additional required disclosures clearly present many other share capital related issues such as stock subscriptions, convertible debt, liquidation preferences and dividends in arrears. Exactly as one would expect, complete disclosure of all relevant issues related to both the conversion of debt and the receivable amounts related to the stock subscription are required in both countries. (Ernst & Young 1990, 310-5) The following exhibit provides a summary of required disclosures related to the par value of stock accounts.

Exhibit 3
Capital Shares Disclosure

	US[1]	UK[2]
Common Shares - for each class		
Description of shares	x	x
Authorized, issued and outstanding shares	x	x
Beginning balance	x	x
Ending balance	x	x
Description of changes in balance	x	x
If shares allotted:		
reason for allotment		x
number and value allotted	x	x
consideration received		x
amount receivable on allotment	x	x
Preferred Shares - for each class		
Information required of common shares	x	x
Liquidation preferences	x	
Cumulative dividends payable	x	x
Redemption rights	x	x

[1] (Aldis and Renshall 1990, 58-9)
[2] (Chasteen, Flaherty and O'Conner 1989, 928-42)

UK - SHARE PREMIUM
US - PAID IN CAPITAL

The accounting standards in the US, and the Companies Act in the UK, both dictate that share capital issued be recorded at par value, with any excess consideration received to be recorded in the share premium account. A court case discussed at a later point in this paper underscores the legal significance of this point. An important characteristic of the share premium account is the fact that the share premium is permanent capital of the company. Therefore, the balance in the share premium account is technically not available for distribution to the stockholders. As discussed in the previous section, the technical restriction on distribution of the share capital and share premium has been avoided in the US by corporate ability to make stockholder distributions on the basis of net fair market value of company assets in some states.

Severe restrictions exist as to the possible direct applications of the share premium in both the US and the UK, and the actual accounting procedures for this account are identical in both countries. Therefore, this discussion will concentrate on the means available to apply the share premium in each country.

UK Treatment

The Companies Act of 1989 specifically states that the share premium account may be reduced only in the following manners: 1) "in paying up unissued shares to be allotted as fully paid bonus shares to members *(stockholders)*, 2) in writing off the company's preliminary expenses or expenses ... on any issue of shares or debentures of the company, or, 3) in providing for the premium payable on redemption of debentures of the company." (Aldis and Renshall 1990, 188-9) While these are the only permitted uses as stated by the law, some companies have found alternative justifiable reasons to apply portions of the balance of the share premium account. For example, a few companies have successfully petitioned the courts to allow the application of share premium to write-off purchased goodwill at the time of a consolidation. (Davies, Paterson and Wilson 1990, 213-4) Additionally, the group

reorganization regulations contained in Section 132 of the Companies Act of 1985 (discussed in this paper in the section titled Merger Reserve) have been successfully applied, with the result of increasing the balance in the share premium account without actually making a capital contribution.

US Treatment

Expenses related to the issuance of stock (e.g. investment banker fees, cost of printing stock, etc.) may decrease the additional paid in capital balance in the US, as in the UK, but expenses related to the issuance or premium paid on redemption of debentures cannot be charged to the additional paid in capital account in the US. The sale of treasury stock, as described in the section of this paper entitled Treasury Stock, at a gain or loss may also impact the balance of additional paid in capital. When a company is insolvent, it may effect a quasi-reorganization, a process that may also alter the balance in the additional paid in capital account. (Chasteen, Flaherty and O'Conner 1989, 980-1) Quasi-reorganizations are further discussed in the section entitled Revaluation Reserve. With the exception of increases caused by the receipt of consideration in excess of the par value of shares issued, and the relatively rare exceptions noted above, the balance in this account should remain stable. (Financial Accounting Standards Board 1990a, 1303)

UK - REVALUATION RESERVE

The revaluation reserve is an "equity" account found in UK financial statements that have no equivalent in US accounting practices. Theoretically, the revaluation reserve is an exceedingly simple account: the balance represents the offsetting credit when asset values are increased from a previously recorded cost to a more current value (presumably higher). The balance associated with any particular asset will eventually be removed from the revaluation reserve when the asset is retired or sold. The balance may also be reduced by charges for depreciation in the years following a revaluation. Due to the continuing nature of business, the revaluation reserve will maintain a credit balance as long as revaluations are performed. If

the practice of asset revaluation is discontinued, the revaluation reserve balance will approach zero as all previously revalued assets are retired or fully depreciated. A detailed description of the current-cost adjustments allowable under the Companies Acts is provided at a later point in this paper.

Although simple in theory, reporting of the revaluation reserve can be very complicated and inconsistent in practice, with companies embracing a multitude of different valuation methods, accounting assumptions, depreciation policies and write-off methods. The revaluation reserve is also commonly used to record unrealized gains or losses from the translation of foreign currency or assets. In fact, for periods beginning prior to December 23, 1989, the revaluation reserve may even contain goodwill acquired in the purchase of other companies, less the related amortization. (Davies, Paterson and Wilson 1990, 208)

UK Treatment

While allowing the revaluation of assets, neither the Companies Acts nor UK accounting standards provide adequate guidance on asset revaluations to ensure inter-company or inter-period comparability of financial statements. All asset revaluation decisions are made by management on an asset-by-asset basis, with no requirement that "all or none" of the assets should be revalued. The Companies Act of 1985 recommends that asset revaluations should be performed annually, but this recommendation is not reiterated in the UK accounting standards, and yearly revaluation seems to be the exception rather than the rule.

If any alternative accounting rule (other than the historical-cost convention) is utilized, additional disclosures are required in the notes to the financial statements to provide at least a general description of the revaluation policies utilized. The company must disclose the basis of valuation adopted along with the amounts that would have been presented had the historical-cost convention been utilized. In addition, the effective date of the revaluation of the assets must be disclosed. (Davies, Paterson and Wilson 1990, 413-36) The following exhibit, displaying an actual revaluation reserve note disclosure, is an extract from Taylor Woodrow P.L.C.'s calendar year 1990 financial statements.

Exhibit 4
Revaluation Reserve Note Example

REVALUATION RESERVES	Consolidated	Company
	£m	£m
31 December 1989	313.7	193.0
Exchange Differences	(14.4)	-
Balance for the year retained	24.0	10.7
31 December 1990	323.3	203.7

The consolidated revaluation reserves include surpluses arising on revaluations of properties, which if realized at 31 December 1990, would have given rise to a maximum taxation liability of £11.7m (1989 - £72.2m), of which £nil (1989 - £3.5m) has been provided in respect of sales of properties since the year end.

No detailed requirement exists regarding the disclosure of the policies used to identify the specific assets chosen to be revalued, and the previous example displays a typical note disclosure containing very little information. Nevertheless, some companies have recognized the potential for misunderstanding in this area and have included extremely comprehensive note disclosures in the financial statements.

The statutory basis for the revaluation of assets is contained in the Companies Act of 1985. The alternative accounting rules contained in Schedule 4, Paragraph 31 give statutory authorization for current-cost adjustments, and detail the specific asset categories available for revaluation as:

1. Intangible fixed assets may be included at current-cost,
2. Tangible fixed assets may be included either at their market value ... or at their current-cost,
3. Investments under current assets may be included at their current-cost,
4. Investments under fixed assets may be included either at:
    a. market value at *(the date of)* valuation, or
    b. any appropriate value as determined by the directors - but the valuation method must be justified in the notes to the financial statements.

5. Stocks may be included at current-cost.

Current cost is defined as the lower of net current replacement cost or the recoverable amount on sale or disposal. (Aldis and Renshall 1990, 52-3)

Assets included in item 2 above, tangible fixed assets, create an additional problem due to the fact that these assets are subject to depreciation. Depreciation of revalued assets is an additional area in UK accounting practice that has been the subject of considerable analysis, interpretation, and criticism. The following example will illustrate a number of alternatives that have been used to account for depreciation related to revalued asset, as recognized by the revaluation reserve. Consider the case of a £400 asset purchased on 31 December 1982, with an estimated life of 4 years (straight line depreciation) and zero salvage value. On 31 December 1984, the asset is determined to have a value of £800, and a 4-year useful life. Note that all three of the options displayed below will have an identical cumulative net effect upon net income when the asset is retired. The choice of accounting method does have a significant timing influence upon the recognition of net income, and upon the gross amount of revenue, gain and expense recognized. (The *Adjusted 1984* column simply reflects the revaluation.)

OPTION A

Charge the portion of the depreciation related to the historical-cost of the revalued asset to the profit and loss account and the portion of depreciation related to the amount of the revaluation directly to the revaluation reserve. (Split Depreciation)

		Adjusted		
31 December	1984	1984	1985	1986
Historical cost basis	400	800	800	800
Less: Accumulated Depreciation	200	___	200	400
Basis	200	800	600	400
Current Profit and Loss:				
Current Depreciation Expense		(100)	(50)	(50)
Revaluation Reserve Balance		600	450	300

OPTION B

Charge 100 percent of the depreciation of a revalued asset to the profit and loss account and transfer the portion of depreciation related to the revaluation to the revaluation reserve before computing current period net income.

31 December	1984	*Adjusted* 1984	1985	1986
Historical cost basis	400	800	800	800
Less: Accumulated Depreciation	200	___	200	400
Basis	200	800	600	400
Current Profit and Loss:				
Current Depreciation Expense		(100)	(200)	(200)
Revaluation Gain		600		
Transfer from Revaluation Reserve		(600)	150	150
Effect on Current Period Income		(100)	(50)	(50)

OPTION C

Charge 100 percent of the depreciation of a revalued asset to the profit and loss account and transfer the portion of depreciation related to the revaluation to the revaluation reserve after computing current period income.

31 December	1984	*Adjusted* 1984	1985	1986
Historical cost basis	400	800	800	800
Less: Accumulated Depreciation	200	___	200	400
Basis	200	800	600	400
Current Profit and Loss:				
Current Depreciation Expense		(100)	(50)	(50)
Transfer from Revaluation Reserve		600	(150)	(150)
Effect on Current Period Income		500	(200)	(200)

The above examples were simplified by always assuming the revaluation entry removed existing depreciation. Increasing the basis sufficiently to cause the depreciated basis to equal the revalued amount is also acceptable. Note also that the revaluation is treated as a

change in accounting estimate (rather than change in accounting principle), therefore no retroactive adjustments are necessary.

Recent UK accounting standards have somewhat clarified the matter by forbidding the use of "split depreciation" (represented by OPTION A). Requiring that the amount of depreciation expense presented on the statement of earnings be derived from the asset values as presented on the balance sheet (in contrast to those values presented in the notes based upon the historical-cost convention) has also eliminated some other confusing financial statement presentation methods. The split depreciation portrayed in OPTION A is a method whereby the proportion of the current year's depreciation expense related to the historical-cost of the applicable asset is charged directly to the profit and loss account, and the remaining amount of depreciation relating to the revalued amount (the increase from historical-cost to current-cost) is charged directly to the revaluation reserve.

Statement of Standard Accounting Practice (SSAP) 12 requires the entire amount of depreciation to be charged to the profit and loss account. The portion of the depreciation related to the revalued amount is then removed from the profit and loss account by a transfer from the revaluation reserve. The method of presenting this transfer is continuing to be an object of controversy. Some companies present the transfer as an adjustment prior to the determination of net income (OPTION B), while other companies present the transfer in the notes to the financial statements (OPTION C). (Aldis and Renshall 1990, 53)

The creation of the revaluation reserve by recognizing the increased values of certain assets also creates other areas of controversy. If a tangible asset is judged to have received a material diminution in value, should the reduction in value be charged to the revaluation reserve or the profit and loss account? Although neither UK standards nor UK statutes address this issue (therefore either treatment is acceptable), a general consensus among management and accounting professionals has evolved. The most widespread practice has been to charge a temporary diminution in value to the revaluation reserve, while charging permanent diminutions in value to the profit and loss account. Theoretically, this practice is only as sound

as management's assessment of the longevity of the value reduction of the asset. (Aldis and Renshall 1990, 54)

The revaluation reserve has one additional use for companies that operate in foreign countries. Statement of Standard Accounting Practice (SSAP) 20 requires all exchange differences on investments in foreign enterprises to be recorded in the reserves and not in the profit and loss account. Exchange differences, as discussed in this paragraph, refer only to unrealized exchange differences. The rationale behind this treatment is that these exchange differences are unrealized gains or losses that do not affect cash flows so therefore should not be recorded in the profit and loss account. Only realized exchange differences may be recorded in the profit and loss account. (Davies, Paterson and Wilson 1990, 364-5)

Exhibit 5 presents a summary of the disclosure requirements for any amounts recorded in the revaluation reserve.

Exhibit 5
Revaluation Reserve Disclosure

FOR EACH CLASS OF ASSETS

IF HISTORICAL RULES ARE USED ON BALANCE SHEET:
Balance at beginning and end of period based on historical (required) or alternative rules (optional)
Balance at beginning and end of period for accumulated depreciation related to item above
All acquisitions, disposals and transfers
All revaluation surplus and deficit movements
All movements related to exchange differences
Depreciation charge for the period

IF ALTERNATIVE RULES ARE USED ON BALANCE SHEET:
All items above restated to conform to historical-cost convention
Explanation of differences between historical and alternative amounts presented
Basis of alternative valuation

(Davies, Paterson and Wilson 1990, 437-48)

US Treatment

Although US GAAP does not contain any provisions for the revaluation of assets in the form of GAAP, limited acceptance of revaluation is given in FASB *Statement of Concepts 5*. *Statement of Concepts 5* states that, on a case by case basis, "Information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information." (Financial Accounting Standards Board 1990b, 782) Theoretical approval has not yet been translated into actual authoritative GAAP at this point in time.

The quasi-reorganization process achieves many of the same results as an asset revaluation. A quasi-reorganization is an accounting procedure available to insolvent (liabilities greater than assets) companies in many states. Procedurally, the term quasi-reorganization can denote two different situations: 1) the reclassification of a deficit in retained earnings as a reduction in additional paid in capital, and, 2) the reclassification of a deficit in retained earnings as a reduction in additional paid in capital in addition to a restatement of the carrying values of assets and/or liabilities.

By definition, this procedure involves a credit to retained earnings and a debit to additional paid in capital. Quasi-reorganizations cannot be equated to the UK practice of asset revaluations, although similarities exist. Quasi-reorganizations are only available to companies with a retained earnings deficit, and the balance in the retained earnings account may not be raised above zero by the quasi-reorganization. Any excess caused by the revaluation of assets and liabilities is credited to additional paid in capital. In many cases (although not necessarily) companies performing a quasi-reorganization are also under bankruptcy proceedings. (Clark and Lorenson 1989, 1-3, 99-173)

US financial statements may also contain foreign exchange differences in the stockholders' equity section of the balance sheet in some instances. These arise when US companies translate the results of foreign operations from the functional currency to US dollars for reporting purposes. The FASB defines functional currency as the currency used in the

primary environment where a relatively self contained foreign entity operates. The foreign exchange difference arises upon the translation of amounts stated in the functional currency into the currency of the parent organization for consolidation purposes. The general rule states that revenues and expenses should be translated into the reporting currency at the time the transaction is realized. These translation differences are included in the determination of net income. But, similar to UK requirements, US GAAP does not allow fluctuations in the exchange rate to affect the measurement of net income for the period on unrealized transactions. Foreign denominated assets and liabilities are generally required to be translated into the reporting currency as of the date of the balance sheet. The net translation difference on such long-term assets and liabilities is recorded in the stockholders' equity section of the balance sheet, bypassing the determination of net income. (Financial Accounting Standards Board 1990a, 19251-75)

UK - CAPITAL REDEMPTION RESERVE
US - TREASURY STOCK

Both the US and the UK maintain accounting practices requiring the maintenance of a comparable capital base when a company repurchases its own stock for investment or retirement purposes. The accounting practices required in both countries help protect the creditors of an organization by ensuring that the non-distributable capital of an organization cannot be withdrawn by shareholders through treasury stock transactions. Although accounting treatments in the two countries are not identical, each method achieves the same result in the instance of retirements: transferring at least the par value of the shares repurchased from distributable profits to part of the restricted capital base of the company. A significant difference between the US and the UK treatments is the UK Companies Act requirement that all repurchased stock be permanently retired. (Aldis and Renshall 1990, 239)

UK Treatment

Until the Companies Act of 1981 was enacted, UK companies were prohibited from purchasing their own shares. In fact, UK companies are currently forbidden to provide financing assistance to other parties (related or unrelated) to encourage the purchase of company shares. When a UK company does repurchase previously allotted shares, the UK accounting requirements differentiate the treatment of the purchase by considering the source of the funds used to repurchase the shares. The two categories established are: 1) proceeds from any source, other than a new issue of shares sold for purposes of a redemption, and 2) proceeds from a new issue of shares sold for purposes of a redemption.

Proceeds from Other than a New Issuance

UK GAAP requires an amount equal to the par value of stock repurchased by a company to be transferred from the share capital account to the capital redemption reserve account. The capital redemption reserve is a statutory non-distributable reserve. This simple procedure ensures the total of share capital and non-distributable reserves remains constant both before and after any treasury stock transactions. Naturally, the share capital account, representing the par value of shares outstanding, will be reduced by the share repurchase, and a corresponding amount will be permanently frozen in the capital redemption reserve, resulting in a static balance in total non-distributable capital. The issue of whether the repurchased stock was originally sold for an amount greater than the par amount may be completely ignored, or, alternatively, any premium paid on the repurchase may be met out of share premium to the extent of any share premium recorded on the original sale of the shares. (Davies, Paterson and Wilson 1990, 597-607) All remaining premium paid on the repurchase of company shares must be recorded as a reduction in distributable profits.

Proceeds from a New Issuance

When company stock is repurchased using funds from a new issuance of stock, the purpose of which is to redeem outstanding shares, the company may be able to reduce the amount that is required to be transferred to the capital redemption reserve. Adjustments are

recorded relating to both the par value of the shares redeemed and the premium received (if any) on the original sale. In the instance of stock repurchased with funds from a new issuance, the general rule states that first an amount equal to the difference in par values (shares repurchased less new share issuance) must be recorded in the capital redemption reserve. Then, an additional amount equal to the lesser of 1) the premium received on the original sale of the redeemed stock, or 2) the current balance in the share premium account must also be transferred to the capital redemption reserve from the share premium account. This amount is permanently frozen in the non-distributable capital redemption reserve, and will remain in this account for the life of the company. (Davies, Paterson and Wilson 1990, 597-607)

US Treatment

US GAAP also segregates the accounting treatment for the repurchase of a company's shares into two different categories, but on a different basis: management's intended purpose for the repurchase of shares. The accounting standards establish these two different situations: 1) capital stock purchased with an intent to retire the shares (or constructively retire the shares), and 2) capital stock purchased for any other reason.

Intent to Retire

When management repurchases outstanding shares with the intent to retire these shares, the par value of the shares is removed from the stated value of shares account (common stock or preferred stock) while any excess of purchase price over the par value may be distributed in any rational manner between additional paid in capital and retained earnings, subject to the following restriction. The maximum allocable to additional paid in capital is limited to the sum of 1) all additional paid in capital arising from previous retirements and net "gains" on sales of treasury stock of the same issue, and 2) the pro rata portion of additional paid in capital, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue of capital stock. Any excess of the par value of the stock repurchased over the purchase price shall be credited to additional paid in capital.

No Intent to Retire

When a company repurchases its own shares with no intent to retire the stock, the company can choose between two accounting options: the cost method and the par value method. The cost method requires the cost of the investment in company stock to be included as a reduction in stockholders' equity under the account title investment in treasury stock. Using this method, any "gain" on the subsequent resale of treasury stock, is treated as an increase in additional paid in capital. Any "loss" on the subsequent resale of treasury stock is treated as a decrease in additional paid in capital, but only to the extent of previous "gains" on the same class of stock. Any additional "loss" on the subsequent resale must be debited to the retained earnings account. The retained earnings account may be decreased, but never increased, by a company's transactions in its own stock. The cost method essentially treats the repurchased shares as an investment by recording the repurchased shares at a historical-cost basis until the subsequent resale. (Chasteen, Flaherty and O'Conner 1989, 945-6) While a company holds an investment in its own shares, the company is required to transfer an amount equal to the repurchase price from the retained earnings account to a restricted (from distribution) retained earnings account.

The par value method roughly approximates the UK method of accounting for treasury stock by viewing the acquisition of a company's own shares as the equivalent of a retirement. Under this method, when a company's own stock is repurchased, the original sale entry is reversed. The par value of the stock is debited to the treasury stock account, an amount equal to the premium paid on the original sale of the shares is removed from additional paid in capital, and any remaining consideration given is debited to retained earnings. If the shares are repurchased at a price less than the original issue price, the "gain" remains in additional paid in capital. When these treasury stock shares are subsequently resold, the accounting is identical to any other sale of stock, except that the treasury stock account is credited rather than the common stock account as in an original issuance. (Chasteen, Flaherty and O'Conner 1989, 947-8) As when the cost method is used, the cost of the shares repurchased must be

removed from retained earnings and held in restricted retained earnings, preventing this amount from being distributed to stockholders' until the treasury shares are resold.

The following exhibit presents a summary of required disclosures for treasury share transactions in both the US and the UK.

Exhibit 6
Treasury Share Disclosure

	US[1]	UK[2]
Shareholder authority to repurchase shares		x
Number, par value and class purchased *or*	x	x
percentage of called up shares purchased		x
Consideration paid for purchase	x	x
Reason for purchase		x
IF PURCHASED OTHER THAN OPEN MARKET:		
Names of seller(s) of shares	•	x

•US GAAP does require additional disclosure if the purpose of the repurchase is made at a premium to market value and involves an unidentified issue (i.e. the purchase of additional rights from the shareholder).

[1] (Financial Accounting Standards Board 1990, 6126-7)
[2] (Davies, Paterson and Wilson 1990, 597-603,1072)

UK - RESERVE FOR GOODWILL

Purchased goodwill represents the excess price paid by a purchaser company for an interest in the identifiable net assets of an acquired company above and beyond the fair market value of those assets and liabilities. On this point US and UK GAAP agree. Other than this, and the consensus that only purchased goodwill may be recorded, UK and US GAAP have very little in common. Unlike US accounting standards, UK laws and accounting standards do not necessarily recognize this additional price paid as an intangible asset instead; this additional price paid is most commonly treated as a reduction in stockholders' equity.

UK Treatment

Under UK accounting standards, a large variety of options are available for the disposition of purchased goodwill representing the entire range from immediate expensing, to capitalizing as an asset. Indeed, a company may even record the goodwill as a debit balance in the stockholders' equity section of the balance sheet. This debit balance in the stockholders' equity section of the balance sheet may or may not be subject to amortization. In fact, the only theoretically supportable treatment that has been forbidden is treating goodwill as a permanent asset not subject to any reduction in value as recognized through periodic amortization expense.

UK laws and standards specifically permit two methods: 1) the creation of an asset account that is subject to amortization and, 2) the immediate write-off to unspecified reserves, although the law does not provide much additional detail. (Ernst & Young 1990, 78-83) Amortization of any amount of goodwill recorded as an intangible asset is required, but the laws and standards do not address the issue of amortization of any balance immediately written off to the reserves. A variety of treatments have become popular including the election made by some UK companies to establish a separate goodwill reserve account within the stockholders' equity section of the balance sheet. This account (if used consistently) is the approximate equivalent of the asset account entitled goodwill mandated by US GAAP. The account simply carries a debit balance until all of the goodwill has been completely amortized (if amortization is taken) to the profit and loss account. (Davies, Paterson and Wilson 1990, 205-17) The exhibit on the following page portrays Beazer, P.L.C.'s rather limited note on the reserve accounts in the fiscal 1989 financial statements. Note the lack of information on goodwill, and the difficulty in ascertaining the composition of the balance in "Other reserves."

Exhibit 7
Reserve Note

Reserves

Group	Share premium account £m	Revaluation reserve £m	Other reserves £m	Profit and loss account £m
At 1st July 1989	241.6	0.1	619.7	206.5
Premium on allotment	4.0	-	-	-
Currency realignment	-	-	(87.3)	(8.8)
Arising on acquisitions	-	-	(14.4)	-
Issue costs of shares in a subsidiary	-	-	(0.6)	-
Retained profit for the year	-	-	-	12.7
At 30th June 1990	245.6	0.1	517.4	210.4

The group's other reserves principally relate to the surplus arising on the acquisition of subsidiaries.

In the UK, amortization of goodwill is also treated slightly differently than in the US. US accounting standards prescribe a 40 year maximum amortization period and the use of straight-line amortization (unless another method can be justified as more appropriate), and many firms adopt this maximum amortization period in the US. In contrast, the European Community (EC) Seventh Directive on companies law recommends a period of five years. The unification of the European common market has had great influence on the recent evolution of UK accounting standards in general, and on the proposal in the area of goodwill in particular.

An Exposure Draft, ED 47, is now outstanding in this area, and, if ED 47 eventually becomes a standard, it would largely standardize the amortization periods used in the UK, which currently range from 5 to 40 years. The ED suggests that goodwill be amortized over the useful life of those characteristics that gave rise to the goodwill, while also claiming that only in exceedingly rare circumstances will the useful life be greater than 20 years. Any period greater than 20 years would require substantiation in the notes to the financial statements, and periods exceeding 40 years would be prohibited. The ED would also require straight-line amortization, whereas any systematic method may currently be used; and some highly original methods are being practiced. (Davies, Paterson and Wilson 1990, 205-17) Charterhall P.L.C.'s

notes to the 1989 financial statements, presented in Exhibit 8, provide an example of one unusual method.

Exhibit 8
Goodwill Amortization Note

INTANGIBLE ASSETS

Goodwill
On the acquisition of subsidiaries and businesses, the purchase consideration is allocated over the underlying net tangible assets and goodwill. Goodwill arising on the acquisition of subsidiaries has been capitalized and is amortized (*after taking account of the anticipated impact of inflation on future earnings*) (emphasis added) through the Profit and Loss Account over a period not exceeding 40 years, estimated by the Directors to be the useful economic life.

On the acquisition of associated companies which are deemed non-core activities, goodwill is written off to Reserves.

	Goodwill £'000
Cost	
At 1 July, 1988	10,232
Additions	49,120
At 30 June, 1989	59,352
Amortization	
At 1 July, 1988	44
Charge for the year	138
At 30 June, 1989	182
Net Book Value	
At 30 June, 1989	59,170
At 30 June, 1988	10,188

The reserve for goodwill account would seem to be a logical destination for positive or negative goodwill if the process is consistently followed--theoretically as sound as the US requirement to record goodwill as an asset. Unfortunately, no single requirement currently exists for the treatment of goodwill, and each company seemingly treats goodwill differently.

Charterhall P.L.C., displayed in Exhibit 8 above, records a portion of goodwill as an intangible asset on the balance sheet and a portion in the reserves section of the balance sheet.

Moreover, many companies have changed goodwill accounting methods over the course of operations without retroactively adjusting the existing goodwill balance at the time of the change in accounting method, with the result that goodwill may be recorded in a number of different reserve accounts in the financial statements. As mentioned in the section of this paper analyzing the revaluation reserve, goodwill was permitted to be charged to the revaluation reserve prior to December 23, 1989. If a company purchased additional goodwill since this date, the remaining goodwill balance in the revaluation reserve is not required to be combined with the new goodwill purchased.

When analyzing UK financial statements, the optional account, reserve for goodwill, merits special attention due to the unpredictability of the nature of the balance. The only reliable method to always ensure that all unamortized purchased goodwill is recorded in this account is to review multiple previous years' financial statements. Additional common treatments have been to immediately expense the goodwill at the time of purchase directly to the profit and loss account, and to charge the goodwill to the optional merger reserve. (Aldis and Renshall 1990, 19-21) The merger reserve is discussed in the next section of this paper.

US Treatment

Accounting for purchased goodwill in the US is very standardized. Purchased goodwill is classified as an intangible asset subject to periodic amortization expense. The amortization period is determined by considering the useful life of all factors that gave rise to the goodwill, although the period is not to exceed 40 years. The amortization is expensed through the profit and loss account. (Chasteen, Flaherty and O'Conner 1989, 567-76) The following exhibit indicates the extent of required disclosure relating to the goodwill in both the UK and the US.

Exhibit 9
Goodwill Disclosure

	US[1]	UK[2]
Goodwill accounting policies	x	x
Goodwill recognized per acquisition		x
Goodwill amortization policies	x	x
Amortization period for each acquisition	x	x
Book value prior to date of acquisition vs. fair value as of date of acquisition for each acquisition		x
Explanation of changes in goodwill balance	x	x
Disposition of purchased goodwill upon the subsequent disposal of the acquisition		
Cumulative amount of goodwill expensed to date		x

[1] (Financial Accounting Standards Board 1990a, 26635-41)
[2] (Aldis and Renshall 1990, 87-9)

UK - MERGER RESERVE

Again, this account has no equivalent in the US GAAP accounting system. This particular reserve is usually created to simplify the accounting for a distinctive accounting treatment allowed in British law under Sections 131 and/or 132 of the Companies Act of 1985.

Section 131

The merger reserve, which is sometimes combined with the capital reserve, is not a statutory reserve; therefore, no specific accounting rules exist for this account. In many instances, the merger reserve account has been created to recognize the existence of the previous application of the merger relief provisions of Section 131 of the Companies Act of 1985. Section 131 was the end result of over ten years of legal proceedings and accounting discussions that finally climaxed in 1980 with the tax court decision, *Shearer v. Bercain Limited.* This decision forbade the application of accounting practices allowing the issuance of shares to be recorded at less than the fair market value of consideration received. The tax court upheld the legal

mandate requiring that when a company issues shares, all fair market value of consideration received exceeding the par value of the shares issued must be transferred to the share premium account. In this manner, *Shearer v. Bercain Limited* effectively outlawed merger accounting, requiring all business combinations to be accounted for as acquisitions.

Immediately following the landmark *Shearer v. Bercain Limited* decision, laws were enacted to allow a company to record shares issued for the purpose of a merger at par value. These laws were later incorporated into the Companies Act of 1985, and are now known as Section 131. Merger relief is similar to, but should not be confused with merger accounting, as merger relief is concerned with the protection of creditors through the maintenance of an non-distributable capital base, and is applicable independent of the specific accounting treatment used for the business combination, while merger accounting describes the form of a business combination. (Davies, Paterson and Wilson 1990, 176-7) The following journal entry (Exhibit 10) illustrates an extremely simple application of the merger relief provisions. The balance sheet presentation of the transaction below is presented in Exhibit 12.

Exhibit 10
Merger Relief Journal Entry

Inland Steel P.L.C. owns 2,000 of the 8,000 outstanding common shares of Land Engineering Limited with a basis of £26,000. Land Engineering has a fair market value of £120,000 on December 31, 1991, when Inland purchases 5,500 additional common shares of Land Engineering by exchanging 1,500 common shares of Inland (£0.10 par value) and £10,000. Common shares represent 100 percent of Land Engineering's share capital. Inland would make the following journal entry:

	Debit	Credit
Investment in Land Engineering (10,000 + 150)	10,150	
Cash		10,000
Common shares (1500 x 0.10)		150
To record the acquisition of 5,500 common shares Land Engineering, and apply the provisions of 90 percent merger relief.		

The merger relief provisions displayed above are triggered when the acquiring company issues equity share capital for the purpose of securing a holding of at least 90 percent of the equity share capital of another company. The acquiring company must secure a holding of 90 percent of the equity share capital of all outstanding classes of equity share capital to apply the merger relief provisions. For the purpose of the merger relief provisions, equity share capital is defined as ownership shares with unrestricted participation in the dividends, return of capital, or both.

In the case of piecemeal acquisitions, the merger relief provisions are only applicable to the arrangement whereby the 90 percent threshold discussed above is reached. The wording of law specifically applies the merger relief provisions to the entire arrangement, not simply the transaction, which causes the 90 percent threshold to be reached. Therefore, in cases of stock acquisitions spread over a period of years, application of Section 131 merger relief could possibly (and often does) entail retroactive adjustments to prior period financial statements.

The effect of the merger relief provisions of Section 131 is essentially a relaxation of the requirement that if a company issues its shares at a premium, regardless of the form of the consideration, any amount exceeding the par value of the shares issued must be transferred to the share premium account. In effect, the acquiring company is permitted to record the equity share capital issued in consideration for the ownership interest in an acquired company at the par value of the shares issued. Accordingly, the ownership interest in the acquired company may also be recorded at the par value of the shares issued. (Aldis and Renshall 1990, 189-90) As with any business combination, complete disclosure is required. The disclosure requirements are illustrated in Exhibit 11. Note the disclosures related to the subsequent disposal of business combinations that utilized the merger relief provisions of Section 131.

Exhibit 11
Merger Relief Disclosure

Name of company acquired
Number, par value, and class of shares acquired
Number, par value, and class of shares allotted
Accounting treatment adopted by acquiring company
Effect (if any) on group results of prior periods
In the case of subsequent disposal of an acquisition within past 3 years:
- Profit on disposal of shares within past 3 years
- Profit on disposal of assets within past 3 years
- Description of any asset transfers within past 3 years

(Davies, Paterson and Wilson 1990, 233-4, 240-1)

Section 132

Section 132 of the Companies Act of 1985 serves as the other common justification for the creation of an optional merger reserve. When the requirements of this section are met, companies are permitted to record equity share capital issued for the purposes of an internal group reorganization at the par value, with limited relief from recording the related share premium received.

Section 132 governs the accounting treatment of the issuance of share capital in cases of a *wholly-owned* subsidiary allotting shares to either its parent company, or another wholly-owned subsidiary of its parent. A company may only apply Section 132 when the consideration received for the issuance of the share capital is other than cash. Naturally, this limitation on the form of consideration does not hinder the exchange of share capital, which is the most likely form of consideration to be received when the purpose of the transaction is a capital restructuring. The general effect of Section 132 is as follows: when a wholly-owned subsidiary issues share capital to a related wholly-owned subsidiary or the parent organization, and the par value of the share capital issued is less than the fair market value of the consideration received, the issuing company is not required to transfer the premium received to the share premium account.

This exemption from recording the share premium received is subject to one limitation. The issuing company must transfer the *minimum premium value* to the share premium account. The minimum premium value is defined as the amount (if any) by which the net book value of the consideration received exceeds the par value of the stock issued at the time the transfer is made. (Aldis and Renshall 1990, 190-91) Due to legal restrictions upon the issuance of share capital at a discount, a company must be very careful to receive at least the par value of the shares as consideration. Consider the following example (Exhibit 12) of journal entries to record a Section 132 reorganization:

Exhibit 12
Group Reorganization Journal Entries

Fargon Holdings Limited owns 1,000 of the outstanding shares of two subsidiaries (representing a 100 percent ownership interest in each): Peazer Limited and Brickell Limited. Fargon's investment in Brickell is recorded at a book value of £5,000. Brickell has a net book value of £20,000 and a fair market value of £40,000. Fargon wishes to retain ownership of the Peazer shares, but desires Peazer to assume ownership of the Brickell shares. If Fargon sold the Brickell shares to Peazer, the question of a gain or loss would arise, therefore a group reorganization is undertaken.

Peazer issues 1,000 £1 shares to Fargon in exchange for the 1,000 shares of Brickell in Fargon's possession.

ENTRIES BY PEAZER:

	Debit	Credit
Investment in Brickell	1,000	
Common shares		1,000
To record the issuance of shares.		
Investment in Brickell	4,000	
Share Premium (5,000 - 1,000)		4,000
To record the minimum premium value.		

ENTRIES BY FARGON:

	Debit	Credit
Investment in Peazer	5,000	
Investment in Brickell		5,000

The following table presents the required disclosures when a group reorganization is undertaken, but these disclosures should only modify the individual company statements, not the group as a whole, because the differences should be removed upon the consolidation, bearing in mind the requirement that group reorganizations be applied to only wholly-owned subsidiaries. (Aldis and Renshall 1990, 190-91) Note the disclosures related to the subsequent disposal of business combinations that utilized the group reorganization provisions of Section 132 presented in Exhibit 13.

Exhibit 13
Group Reorganization Disclosure

IF ACCOUNTED FOR AS A MERGER:
Names of the combining companies
Number and class of securities issued
Description of any other consideration given
Nature and amount of any accounting adjustments
made to achieve inter-company consistency

IF ACCOUNTED FOR AS A PURCHASE:
All of the information required above
Effective date of the acquisition
Goodwill accounting policies
Goodwill recognized per acquisition
Goodwill amortization policies
Amortization period for the acquisition
Book value prior to date of acquisition vs. fair value as
of date of acquisition for each acquisition
Explanation of reasons for differences between book
values and fair values in item above
Subsequent disposal of the acquisition

(Davies, Paterson and Wilson 1990, 233-240)

Accounting Presentation of Section 131 or 132

When an acquiring company meets the requirements of Section 131 and/or 132 presented above (these requirements are presented in a very condensed form, the actual law should be consulted for complete understanding), two accounting options are available to the acquiring

company when recording the transaction: 1) to record the shares issued, and the investment in the acquired company, at the par value of the shares issued, plus any other consideration given (and any minimum premium value, if any), or, 2) to record the shares issued at the par value of those shares, record the investment in the acquired company at the fair market value and record the excess of the fair market value of the investment over the par value of the shares issued as a merger reserve. The application of either Section 131 or 132 precludes the application of the other section, as the law defines the two sections as mutually exclusive. The following exhibit displays the two disclosure treatments available to companies illustrated in Exhibits 10 and 12.

Exhibit 14
Revaluation Reserve Presentation

	Book value	Fair market value
PRESENTATIONS AVAILABLE TO INLAND STEEL (Exhibit 10):		
Investment in Land Engineering	36,150	*112,500
Revaluation reserve		•(76,350)
*(7,500/8,000 x 120,000 = 112,500)		
•(112,500 - 36,150 = 76,350)		
PRESENTATIONS AVAILABLE TO PEAZER (Exhibit 12):		
Investment in Brickell	5,000	40,000
Revaluation reserve		∞(35,000)
∞(40,000 - 5,000 = 35,000)		

A subtlety in the wording of these two sections of the Companies Act has allowed companies some latitude in the selection of methods. Section 131 confers permission to avoid recording the share premium by stating that the requirements to record a share premium do not apply, then Section 131 explicitly forbids the share premium to be recorded when Section 131 is applied. On the other hand, Section 132 also confers permission to avoid recording the share

premium by stating that the requirements to record a share premium do not apply, but does not specifically forbid the optional application of these same requirements. Some companies that have desired to increase the restricted capital base have used the group organization rules contained in Section 132, and optionally recorded the share premium, to achieve these results. (Aldis and Renshall 1990, 191-2)

UK - PROFIT AND LOSS
US - RETAINED EARNINGS

The many differences in revenue recognition between the US and the UK are all reflected in the accumulated earnings and profits account. To illustrate the nature of the differences, two areas will be analyzed. The first area to be examined is the revenue recognition principles in use in each accounting system. The second area is accounting for deferred taxes. This second area was selected due to the significant variance deferred taxes creates between US an UK financial statements. Please refer to Exhibit 1 to view an example of the relative composition of US vs. UK GAAP differences, including the large adjustment for deferred taxes.

Revenue Recognition

This section will discuss the revenue recognition principles utilized in both the US and the UK in very broad terms. Numerous exclusions and specific industry practices alter these broad principles. Both systems have many characteristics in common, and both systems have been created from the concepts of accrual accounting, matching and conservatism. The relative importance attributed to either of these sometimes conflicting concepts is the basis of the dissimilarities in revenue accounting between the US and the UK.

UK Treatment

UK GAAP does not contain a definitive statement on revenue recognition. The traditional policy of recognizing revenue at the point of sale has become more difficult as revenue producing activities have become more complex. SSAP 2, *Disclosure of Accounting*

Policies, claims that "revenue and profits are not anticipated, but are recognized by inclusion in the profit and loss account when realized in the form either of cash or of other assets, the ultimate cash realization of which can be assessed with reasonable certainty." (Accounting Standards Board, 1971, para. 4) This statement infers that the critical event needed to recognize revenue is the creation of a high probability of receiving cash or a cash equivalent. This conclusion is in direct contrast with the Companies Act opinion that revenues should be recognized when it is reasonably certain that those revenues have been realized. Unfortunately, neither UK GAAP nor UK Companies law provides a definition of "realized."

The Accounting Standards Board also issued a technical release (TR 481) concluding that when a statement of accounting standards required an amount to be included in the profit and loss account, that amount should be considered realized. (Davies, Paterson and Wilson 1990, 83-114) Authors Davies, Paterson and Wilson are extremely critical of the lack of consistent revenue recognition practices.

US Treatment

Accounting Principle Board (APB) *Statement No. 4* states the general rule of revenue recognition as "revenue is generally recognized when both of the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place." *Statement of Accounting Concepts 5* provides a slightly different interpretation by claiming that revenues should be recognized when earned, and one of the two following situations exist: (1) the revenues are realized; defined as "when products (goods and services), merchandise, or other assets are exchanged for cash or claims to cash, and (2) when revenues are realizable; defined as "when related assets received or held are readily convertible to known amounts of cash or claims to cash." (Financial Accounting Standards Board 1990b, 781)

The two rules above present a clearer idea of revenue recognition than the UK model, but also leave much to be desired in the area of consistency. US revenue recognition rules seem to be industry specific. These rules are a patchwork of accounting standards that have evolved over the years in response to an immediate problem at hand.

Analysis of Revenue Recognition

The number and complexity of financial instruments and contracts has grown too rapidly for standard-setting bodies in the US or the UK to develop a rational, internally consistent framework of revenue recognition standards. The FASB in the US and the ASB in the UK have responded in typical fashion. The FASB has issued volumes of standards in every area of controversy (i.e. - franchise fees, royalty fees, computer software licensing fees, construction contracts, etc.) in an attempt to provide guidance on each new type of financial instrument. Meanwhile, the private sector has continued structuring financial instruments for the purpose of avoiding the FASB standards. The ASB has simply delegated the responsibility for the proper presentation of revenues to individual accountants, after setting very broad standards.

Neither standard-setting body seems able to decide at what point a revenue should be recognized. The emphasis upon the receipt or constructive receipt of cash or a cash equivalent is quite puzzling. Take the example of a company selling 50 percent of its annual output to its primary customer in exchange for a 15 percent equity interest in that primary customer. If the company was contractually obligated to retain that equity interest for 10 years, can this be considered a revenue? The company has not received cash, or a claim for cash, for the foreseeable future, although the equity may possibly be used for loan collateral. A company in either country could arguably treat this as a revenue or a deferred revenue.

Deferred Taxes

Deferred tax is the term used to describe the anticipated tax effect on gains and losses recognized for financial accounting purposes, but not for taxation purposes (temporary differences). The accounting practices required for deferred taxes in the US and the UK create substantial differences in financial statements in the respective countries.

UK Treatment

The UK treatment of deferred taxes is based on the partial recognition of an anticipated future amount. The standards require a balance sheet approach, by mandating the estimation of the amount of reversal of deferred tax liabilities in the imminent future. The

company must determine the amount of deferred tax liability that will become payable in the next 3 - 5 years, and report this amount on the balance sheet. The remaining expected liability (due after 3 -5 years) must be disclosed in the notes (Davies, Paterson and Wilson 1990, 836-43). The following extract from the Pilkington P.L.C. 1990 financial statements provides an example of a deferred tax note disclosure.

Exhibit 15
Deferred Taxation Note

	1990 £m	1989 £m
The balances included in the provisions relate to:		
Capital allowances in excess of related depreciation	11.6	11.2
Other timing differences:		
provisions and accruals	8.4	8.3
future benefit of tax losses	(1.6)	(.1)
recoverable UK advance corporation tax	(1.4)	(3.1)
	17.0	16.3
Deferred taxation which has not been provided:		
Capital allowances in excess of related depreciation	169.7	179.0
Revaluation of fixed assets and capital gains	95.2	86.2
Other timing differences	(53.3)	(37.7)
	211.6	227.5

US Treatment

US GAAP also recognizes deferred tax liability with a balance sheet approach, but on a far more comprehensive basis than UK GAAP. The deferred tax liability must reflect all temporary differences (between financial and taxation accounting), with the exception of those temporary differences meeting the indefinite reversal criteria. The indefinite reversal criteria allows companies to ignore the deferred tax liability on those items that will never give rise to a current tax liability. The US has adopted the requirement to recognize the full estimated deferred tax liability using the balance sheet approach only in recent years. This requirement is effective for all years beginning after December 15, 1992. Previously, companies were

allowed to use a current period, income statement based approach. Consequently, many US companies have recognized, or will recognize, significant deferred tax liabilities when converting to the balance sheet approach. This paper will not discuss the complex requirements of deferred income taxes beyond pointing out the basic reason for the large disparity between US and UK deferred tax liabilities: the time horizon of the accrual period.

RELATED PARTIES

In fairness to creditors, stockholders, and other interested parties, accounting standard-setting bodies around the world have required companies to provide detailed disclosure of company transactions with related parties. Due to the fact that a related party transaction is simply a transaction between related parties, this paper will focus on the two major issues: 1) the identification of a "related party" and, 2) the disclosures required of a related party transaction. Although the technical definition of a related party varies from country to country, a related party can be generally defined to be a party able to exercise either "direct or indirect control or significant influence" over the assets or management of another party, or the relationship whereby two or more parties are subject to common control or significant influence. (Financial Accounting Standards Board 1990a, 38349) Due to the potential for abuse of fiduciary responsibility, most related party transactions require extensive disclosure with the intent of providing financial statement users adequate information to assess the economic substance of the transactions in question. The requirements stop short of requiring companies to disclose pro forma information simulating an arm's length transaction.

UK Treatment

Current UK accounting standards do not address the issue of related party transactions in a direct manner. The only current standards which discuss related party transactions are principally concerned with associated undertakings and requirements to prepare group accounts. These standards only involve related party transaction disclosure as a peripherial issue. The

lack of related party disclosure under UK GAAP has been a point of criticism, and an exposure draft (ED) concentrating solely on the issue of related party disclosure was tabled in 1990.

ED 46, currently under consideration by the UK ASB, provides a very good definition of a related party transaction as "a transfer or granting of benefits or obligations between related parties, irrespective of whether the transactions are recognized in the accounting records or whether consideration passes." (Accounting Standards Board 1990, para. 26) This broad definition attempts to encompass all transactions that may be made at less than arm's length. "Significant influence," as discussed above, may exist at any ownership level but is presumed at an ownership level of 10 percent of the equity. Beyond this 10 percent limit the party involved must substantiate a claim of lack of influence to avoid the additional disclosure requirements. The UK prospective accounting standard, like those in the US, places the focus of accounting for related party transactions upon disclosure; no attempt is made to estimate the value of the transaction had it been undertaken at arm's length.

The proposed UK accounting standard embodied in ED 46 segregates prospective related party transactions into two categories, normal and abnormal. A normal transaction is defined as an arm's length transaction undertaken in the ordinary course of business on usual commercial terms. Normal transactions are exempt from additional related party disclosure unless the transaction is so material that it has a significant impact on the financial statements.

All other transactions that do not meet the definition of a normal transaction are considered abnormal transactions and are subject to the additional related party disclosure requirements. (Davies, Paterson and Wilson 1990, 1049-64) Note that the UK treatment discussed is derived from an exposure draft. In actual practice, UK statements contain very little related party disclosure. The extent of proposed related party disclosure requirements are presented in Exhibit 16 at the end of this section.

US Treatment.

Similar to UK GAAP, US accounting standards define a related party very broadly, while basing the determination of the necessity of disclosure upon the presence of "significant

influence." FASB prescribed practices place the *presumption* of significant influence at a 20 percent ownership level, in contrast to the 10 percent ownership level in the UK. An additional factor used to determine the necessity for disclosure is the potential ability for any transactions to have a material impact upon the financial statements taken as a whole.

The US requirements contain no disclosure exemption for "normal" transactions; instead an exemption is allowed for transactions in the ordinary course of business. (Financial Accounting Standards Board 1990a, 38345-7) A slight difference exists between "normal" and "in the ordinary course of business." To meet the definition of normal, the UK system requires a transaction to be at arm's length, in the ordinary course of business and on normal commercial terms. This slight difference in wording, in addition to the lower ownership level required to presume significant influence, probably will make future UK related party disclosures more informative than their US counterparts, assuming the proposed UK standard is approved. Current UK financial statements present related party disclosures on an optional basis in some cases. Exhibit 16 presents a comparison of *current* US related party disclosure requirements with *proposed* UK related party disclosure requirements.

Exhibit 16
Related Party Disclosure

	US[1]	UK[2]
Name of related party	x	x
Relationship of parties	x	x
Extent of ownership interest		x
Nature of transaction	x	x
Amount of value involved (percent terms)		x
Amount of value involved (£/$ terms)	x	x
Outstanding liabilities/receivables	x	x
Terms and manner of settlement		x
Basis for transaction price		x
Any other necessary information	x	x
Income tax effect	x	x

[1] (Financial Accounting Standards Board 1990a, 38346)
[2] (Davies, Paterson and Wilson 1990, 1053)

DIRECTORS DISCLOSURE

Disclosure focused upon the board of directors and other top management officials of a company is included in this comparative study of equity accounting methods not because these individuals necessarily own large shares of the company, although often this is true, but because of the tremendous influence these people have on all aspects of company operations. This section discusses additional disclosure beyond the simple identification of the directors and other appropriate officials.

UK Treatment

UK accounting standards provide for extensive disclosure of company transactions with officers and directors due to their special fiduciary relationship with the company. Many transactions are prohibited, and almost every material transaction, regardless of the circumstances, must be disclosed in the financial statements. The terms director and officer are defined loosely, specifically including shadow directors, and the idea of a "connected person" which drastically increases the scope of these requirements. "Connected persons" include members of the director's immediate family, companies under the director's control, and partners of the director or the director's controlled enterprises. As a general rule, all transactions with a director are forbidden except those contained in either a compensation scheme or a credit scheme. (Aldis and Renshall 1990, 255-63)

Compensation schemes

Compensation of officers and directors is very legalistic in the United Kingdom. Table A of the Companies Act of 1985 requires that 100 percent of a director's compensation be documented in the director's service contract and in the articles of association. By law, executive compensation may not legally exist outside of the amounts approved in these two venues. Technically, executives are not entitled to receive any additional compensation, directly or indirectly, without these appropriate disclosures. Additionally, each director's

aggregate compensation, regardless of form, must be reported in the notes to the financial statements.

Predictably, enforcement of these requirements has been very problematic. Many difficulties have originated simply from the difficulty of measuring some non-monetary compensation schemes such as stock options. Every non-cash compensation scheme involves a value judgment, and UK accounting standards have not established a consistent standard of measurement.

A preferred method is to include in reported compensation the fair market value of the non-cash compensation, but this appealing method is extremely difficult to apply on a practical basis considering the complexity of some executive compensation plans. The Institute of Chartered Accountants of Scotland has investigated the problem of intentionally structuring executive compensation plans specifically to avoid these requirements. Disclosure requirements have previously been effectively circumvented by appointing a consultancy company to provide management services, effectively creating a shadow directorship. Presumably, the actual director is simply a mouthpiece for the shadow director employed by the consultancy company.

In summary, all transactions in which a company enters into a transfer of value with a director or any entity in which a person with significant influence in the company maintains a material interest must be disclosed in the financial statements. All relevant details concerning the valuation of non-cash transactions must also be disclosed. (Davies, Paterson and Wilson 1990, 1111-25) The following extract (Exhibit 17) from the 1990 John Laing P.L.C. financial statements provides a good example of compensation scheme disclosure.

Exhibit 17
Directors Compensation Note

Directors and employees	1990 £	1989 £
Directors' emoluments comprise:		
Directors' fees	10,000	47,334
Other emoluments including pension scheme contributions	1,238,147	844,685
Total emoluments of 10 Directors (1989 - 13)	1,248,147	892,019
Emoluments, excluding pension contributions and emoluments of those Directors whose duties were discharged mainly outside the United Kingdom		
The Chairman	182,797	165,301
All Directors - numbers receiving remuneration, including incentive payments related to this year, within the following ranges were:		
£5,001 to £10,000	1	4
£15,001 to £20,000	-	1
£20,001 to £25,000	1	1
£30,001 to £35,000	-	1
£55,001 to £60,000	-	1
£80,001 to £85,000	1	1
£115,001 to £120,000	1	2
£120,001 to £125,000	1	1
£130,001 to £135,000	2	-
£140,001 to £145,000	1	-
£155,001 to £160,000	1	-
£165,001 to £170,000	-	1
£180,001 to £185,000	1	-

Loans, transactions and equity

Since 1948, the Companies Acts have attempted to require companies to disclose loans and transactions with directors and parties with significant influence or a material interest with limited success. The existence of a material interest of a director is decided by the remaining uninvolved directors, but the existence of significant influence has been quantified by the accounting standards. The attribution rules used to determine if a person has significant influence are extremely complicated. One is presumed to have significant influence if one has direct or indirect control over 20 percent of the voting capital of a company. (Note that the

presumption of significant interest is at 20 percent rather than the 10 percent discussed in the section entitled Related Parties. This is due to the fact that the Related Parties section discussed an Exposure Draft, while this section discusses existing GAAP.)

Generally speaking, if one has control of a company (over 50 percent interest in voting power), 100 percent of the investment shares owned by the controlled company are attributed to the controlling party. If one owns more than 20 percent, but less than 50 percent, of the voting shares of a company, the proportionate share of the investment shares owned by the influenced company are attributed to the influencing party. Additionally, all business partners' and family members' (among others) interests are attributed to the party in question when determining the presence of significant influence or control.

The current disclosure requirements are consolidated in the Companies Act of 1989. Generally speaking, any transaction (including loans) with a director, or company in which a director has control or significant influence, is required to be disclosed in the financial statements. These same disclosure requirements apply to any person deemed to have significant influence.

No single test for the determination of the existence of a loan is codified in the law or written in the accounting standards. Each transaction must be examined to determine if the director concerned is actually receiving a loan. The word "loan" is used to define any extension of credit. This term encompasses advances of expense allowances, payments to third parties to be reimbursed at a later date, extension of goods and services with deferred payment or company credit cards used for personal purposes. "Section 330" transactions, whereby a company provides security or guarantees for a director (or one with significant influence) are also required to be disclosed.

After each transaction is considered individually, the aggregate amount of liability is computed. The company is exempt from reporting these liability natured transactions, for each director considered individually, if the gross value of the transactions or loans with that director is less than £5,000. (Aldis, and Renshall 1990, 265-83)

US Treatment

US GAAP does not require extensive disclosure of transactions between a company and its fiduciary officers and directors. Provided the transactions do not require disclosure under the provisions involved with related party disclosure, no additional disclosure requirements exist specifically to document the activities of the directors.

Much of the information required by UK law and accounting standards is available for large public US companies. Securities and Exchange Commission (SEC) rules require disclosure of the names and amount of renumeration of the five highest paid personnel, names of significant shareholders, and other relevant information in the annual 10-K report. This information is readily available from the US government for inspection, but the SEC would prefer to also have some of this information disclosed in the financial statements. Exhibit 18 details directors' information required to be disclosed, assuming the related party requirements are inapplicable.

Exhibit 18
Directors Disclosure

	US[1]	UK[2]
Names of directors	x	x
Biographical sketch of directors	x	x
Employment fees paid for each director		x
Other compensation for each director		x
Pensions paid for each director		x
Compensation bonus' for accepting position		x
Compensation for loss of previous office		x
Loans outstanding		
Beginning and ending balance		x
Maximum balance during period		x
Unpaid interest		x
Non-payment penalties		x
Guaranties and securities		
Potential liability		x
Amounts paid		x

[1] (Ernst & Young 1990, 199)
[2] (Davies, Paterson and Wilson 1990, 1077-130)

ANALYSIS

A great many similarities, and a substantial minority of differences, exist between US and UK GAAP. This section attempts to rationalize the differences between the two systems and also attempts to discern an underlying pattern. The stated purpose and fundamental principles in each country provide the basis for discovering the rationale.

The accounting principles underlying GAAP in both countries are basically the same, with mainly semantic differences. Both systems presume the accounting entity to be a going concern in the absence of evidence to the contrary. Both systems require accounting policies to be applied consistently to ensure inter-period comparability. Both systems intentionally bias accounting decisions in a conservative (prudent) manner. Both systems embrace the matching concept and accrual concept. Why then are the results of the two accounting systems so divergent? The answer to this question is partially found in the focus of the accounting systems.

The (UK) Companies Act of 1985 reiterates the long-standing requirement that "the balance sheet must give a true and fair view of the company's state of affairs as at the end of the financial year, and the profit and loss account must give a true and fair view of the company's profit and loss for the financial year [s226(2)]." The statute proceeds to emphasize that a true and fair view is of paramount importance when preparing financial statements.

In fact, the emphasis on true and fair was recently strengthened in the Companies Act by the inclusion of the following two sections:

> 1) Where compliance with the provisions of Schedule 4 and the other provisions of the 1985 Act, as to the matters to be included in a company's individual accounts or in notes to these accounts, would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or in a note to those accounts [s226(4)].
>
> 2) If, in special circumstances, compliance with any of the provisions referred to in 1) is inconsistent with the requirement to give a true and fair view, the directors are required to depart from that provision to the extent necessary to give a true and fair view. Particulars of any such departure, the reasons for it and its effect must be given in a note to the accounts [s226(5)].
>
> (Aldis and Renshall 1990, 7)

Paragraph 2 confers substantial authority to practice alternative accounting methods, if justifiable. The standard UK audit report also places strong emphasis on "true and fair":

> "In our opinion the accounts and notes give a true and fair view of the state of affairs of the company and the group at 31 December 19xx and of the profit and source and application of funds of the group for the year then ended and have been properly prepared in accordance with the Companies Act of 1985."

The US equivalent of an utopian ideal such as universal "true and fair" financial statements is embodied in the conceptual framework project. The self-reported description of the conceptual framework project is stated in the introduction of all concepts statements as "a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting." (Financial Accounting Standards Board 1990b, 765)

Note the completely different focus of these two ideas. The UK requirements urge a company to produce financial statements that are true and fair. The matter of "paramount" importance is the qualitative aspect of the individual company's statements. Additional information is to be added to the financial statements if the required information does not present a true and fair view. In addition, successful legal arguments have been heard justifying the use of accounting practices contrary to UK GAAP, even if, arguably, compliance combined with additional disclosures would have presented a true and fair view. In summary, the two strong currents of thought influencing GAAP in the UK are a focus upon quality of *individual* statements and expansive *disclosure.*

In contrast, US GAAP places greater emphasis on inter-period *consistency* and inter-company *comparability.* Although the wording of a standard US audit report has changed recently, for a number of years a standard report contained the words:

"financial statements present fairly the financial position of the group at December 31, 19xx, and the results of its operations and the changes in its financial position for the year then ended, <u>in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year</u>."

This standard report did claim that the financial statements were presented fairly, but an added emphasis was placed on achieving inter-company (conforming with GAAP) and inter-period consistency. In summary, the focus is not placed on the individual company's financial statement, but on the entire group of public financial statements. By removing a portion of management's authority to decide an appropriate procedure (by requiring standardization), US GAAP necessarily depends more heavily on the form of a transaction to determine the accounting treatment. Where the UK standards attempt to present understandable, accurate financial information by flexibility of standards coupled with extensive disclosure, US standards attempt to communicate financial information by standardizing the analysis and presentation.

The treatment of goodwill is an excellent example of the dissimilarity in focus described above. Conceivably, a multitude of reasons may exist to explain why a company acquires an interest in another company at a purchase price that necessitates recording of goodwill. If, after the purchase has been consummated, the acquiring company discovers that it simply paid too much money for an interest in the acquired company, the goodwill should theoretically be expensed. The question of whether or not the purchased goodwill should be immediately charged directly to the profit and loss account or charged to a contra-equity account such as the reserve for goodwill should be assessed in each individual situation. If the goodwill actually did arise because of a purchased intangible asset, such as a strong brand name, the goodwill should rightfully be recorded as an asset. UK accounting standards establish this flexibility at a price of comparability.

The explicit departure from the historical-cost convention involved in revaluing assets provides yet another example. Although the balance sheet of a company has never been represented as being a current valuation of that company as a going concern (or a liquidation

value for that matter), UK accounting standards embrace the revaluation process as providing a more true and fair representation of the state of affairs of the company. The existence of Section 131 merger relief and the merger reserve reinforces the departure from historical-cost and is conceptually identical to the revaluation reserve.

The existence of Section 132 is even more remarkable in its flexibility. The purpose of Section 132 is to provide the ability to record group reorganizations at less that the fair market value of the exchange in order to grant relief from recording share premium. The Companies Act provides this relief, but also allows companies to record the transaction at fair market value if desired.

The FASB has predictably not followed the UK example of allowing current values on the face of the financial statements. The subject of asset revaluation was considered in the final paragraphs of *Statement of Concepts 5* in 1984, but never fully integrated into GAAP. Current value financial statements are far more foreign to contemporary US GAAP thought patterns, than to those in the UK. Reconciling current valuations with a focus on comparability and consistency is far more difficult than reconciling current valuations with true and fair individual statements.

Both US and UK systems of accounting choose to standardize the treatment for treasury stock transactions, contradicting the difference in focus that is readily apparent in other areas. This is probably because there is little room for interpretation in the issue of treasury shares. But UK GAAP does concentrate upon the "how?" of the purchase. The choice of accounting treatments is conditional on the source of the funds used to purchase the shares. This decision (with no recourse) is entirely decided by management, and with limited repercussions other than the accounting treatment applied to the transaction. After legally compelling the company to retire the shares upon repurchase, the question of the form of how the shares were purchased becomes the only relevant question, due to the necessity of retaining an adequate capital base for the protection of the creditors. Nevertheless, the Companies Act forces standardization to a great extent by requiring the retirement of the repurchased shares.

US GAAP attempts to generalize the repurchase decision by asking the question: "why?" In the case of retirement, or when the par value method is applied, the face of balance sheet will show no evidence of the treasury stock transactions, unless the company optionally restricts the retained earnings account on the face of the balance sheet, instead of in the notes. The cost method simply displays the treasury stock as a reduction in stockholders' equity. Management is permitted to account for the transaction without regard to the form of the transaction, relying entirely upon the stated intent of management. This treatment seems to reflect the UK "true and fair" emphasis more than the US desire for consistency.

Deferred taxes provide yet another example of the emphases of the respective accounting systems. UK GAAP refuses to acknowledge the full potential liability of deferred taxes. This also seems to be consistent with the "true and fair" theory. Experience has taught that many companies maintain a deferred tax liability indefinitely. Although the individual items that compromise the liability may change, the net effect is the same as a permanent difference. UK GAAP acknowledges this fact by allowing management to estimate the liability expected to be due within a short period of time. This relatively short-term liability must be recognized, and the remaining balance is subject to full disclosure in the notes. US GAAP strives for consistency by requiring 100 percent of the potential liability to be accrued. Although huge deferred tax liabilities are created (which undoubtedly will not be paid any time soon), theoretical consistency is achieved.

As the examples above demonstrate, substantial differences exist between US and UK accounting standards. UK GAAP has tremendously more potential for accurate and informative financial statements than US GAAP, but UK GAAP also has tremendous potential for misleading financial statements.

CONCLUSIONS

The differences between US and UK GAAP can be summarized using the familiar US accounting terms of relevance and reliability. This author is not comfortable with the definitions of these two terms as provided by the FASB, therefore both definitions will be slightly expanded from those given in *Statement of Concepts 2*.

The FASB defines relevance as "The capacity of information to make a difference in a decision by helping users form predictions about the outcome of past, present, and future events or to confirm or correct prior expectations." This definition contains a connotation that relevance is an absolute--a value that can exist in isolation. Contrary to this, the relevance of any information is measured by the degree to which the information influences a specific decision. Therefore, one must know the decision being made to assess the relevance of information. Relevance may only be determined in hindsight because information gains relevance in the decision-making process, and not a moment before. Following this thought to the logical conclusion, one can easily conclude that relevance is very subjective and individualistic. This is an extremely important point to consider in any cross-cultural issue. Note the individual perception (regardless of reality) of the reliability of the information under consideration heavily influences the relevance of the information.

The FASB defines reliability as "The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Again, this definition ignores the presence of differing perceptions of an identical item that are common in cross-cultural circumstances. This paper shall define reliability as the degree to which a decision maker perceives information as accurately representing that which he/she believes the information represents. Again, note the judgmental aspect of reliability. Both of these definitions have been expanded to recognize the fact that the decision maker's perception of relevance and reliability is a more important factor in the decision-making process than the relevance and reliability as defined by the FASB.

The information in this paper clearly confirms that UK GAAP requires greater disclosure and allows for greater latitude in professional judgement than US GAAP, as speculated at the beginning of this paper. Extensive disclosures of the directors' activities and ownership interests and the proposed extensive disclosures for related parties provide two excellent examples of the focus of UK GAAP upon disclosure. The multitude of available treatments for purchased goodwill provide a clear example of the flexibility of UK GAAP.

One could correctly conclude that UK GAAP intends to provide a greater quantity of relevant information than US GAAP by requiring a higher degree of disclosure and allowing a far greater degree of professional judgment in the accounting process. The degree to which UK GAAP achieves this stated intent is dependent upon two factors: the perception of the decision maker as to what the information is intended to represent, and the the perception of the decision maker as to the reliability of the information. The fact that UK financial statements provide a greater quantity of information is quite clear, as is the fact that UK financial statements have the potential for greater relevance, but whether or not the information is considered relevant can only be determined by the actual decision maker.

APPENDIX 1 - PRESCRIBED FORMAT OF COMPANY EQUITY ACCOUNTS IN THE UK

Capital and reserves

Called up share capital
Share premium account
Revaluation reserve
Other reserves

1. Capital redemption reserve
2. Reserve for own shares
3. Reserves provided for by the articles of association
4. Other reserves

Profit and loss account

APPENDIX 2 - ACRONYMS USED

APB -	Accounting Principles Board
ASB -	Accounting Standards Board
EC -	European Community
ED -	Exposure Draft
FASB -	Financial Accounting Standards Board
GAAP -	Generally Accepted Accounting Practice
NT -	New Taiwan Dollars
PLC -	Public Limited Corporation
SFAC -	Statement of Financial Accounting Concept
SFAS -	Statement of Financial Accounting Standard
SSAP -	Statement of Standard Accounting Practice
TB -	Technical Bulletin
UK -	United Kingdom
US -	United States

APPENDIX 3 - UK FINANCIAL STATEMENTS ANALYZED

Beazer, P.L.C.
Costain, P.L.C.
Charterhall, P.L.C.
John Laing, P.L.C.
Taylor Woodrow, P.L.C.
Wessex Water, P.L.C.

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