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Editor: KENNETH S. MOST

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College of Business Administration
Florida International University

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ADVANCES IN
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INTRODUCTION

In the Introduction to Volume 4 I drew attention to the problem of oversimplification in international accounting research. A recently published case study provides an illustration of this problem (see Brown and Stickney 1992).

THE TANAGUCHI CASE

Two analysts, recent MBA graduates, undertake the evaluation of a Japanese machine tool company (Tanaguchi) as a possible investment by their employer, a United States investor. They use Tanaguchi's annual report (an English-language convenience translation) and calculate twenty-three financial ratios. These are compared with median ratios of U.S. machine tool companies "for a comparable year" obtained from a credit monitoring agency (Robert Morris Associates), and it is found that in most respects the Japanese company's ratios are less satisfactory. In particular, the comparison reveals that the Japanese company has a lower profitability (return on common equity), higher debt ratio (total liabilities/total assets), particularly high short-term debt, and a much higher price-earnings (market price/net income) ratio.

The analysts demonstrably oversimplify their investment analysis but we will confine ourselves here to the accounting aspects. They observe that the ratio differences may be attributable, in part at least, to the effects of different

Japanese accounting principles, and some of these are identified in two appendices. To make the figures more comparable the analysts proceed to "adjust" the Japanese data and a second exhibit displays the same ratios calculated with the adjusted data, which are then compared with both the old ones and the U.S. medians. Most of the new ratios differ little from the old, only return on assets and price-earnings being significantly improved. At this point, one of the analysts observes that the ratios may need to be interpreted differently because of socio economic and cultural differences between Japan and the United States

THE FINANCIAL STATEMENTS

The case suggests that the use of parent-company only financial statements for the Japanese company significantly affected the ratio comparisons, assuming that the U.S. data were derived from consolidations. It is not explained the Japanese consolidation was not used; it may not have been available in English. The actual situation, however, is far more complex.

From the notes to Tanaguchi's financial statements we learn that the company had a controlling interest in at least one other company, among other investments reported at cost. This should alert us to the fact that U.S. consolidated financial statements often combine data from diversified subsidiaries, and a machine tool company's statements may therefore not represent only machine tool operations. (The Standard Industrial Code is of little help here.) Difficulty in analyzing and interpreting the financial ratios of diversified operations is one of the reasons why the shares of conglomerates tend to underperform the market.

This speaks to the comparative reliability of the data, and there is other evidence that Tanaguchi's data are superior in this respect. First, because Japan is a tax-conformity country, the figures in the annual report must be identical with those in the tax returns; there are severe penalties for contravening the commercial and tax laws in that country. Second, although we do not know the sources of the data used by Robert Morris Associates, they are likely to include some from unaudited financial statements, and even some obtained from responses to questionnaires by companies that were aware of the use to which they would be put. There is more opportunity for "creative accounting" in the United States. Tanaguchi's figures, being the basis for income tax assessment, are likely to be more conservative in reporting both asset values and profit. Some analysts may prefer this, and I have been told by a Japanese investor that one reason why he and his associates did not buy U.S. stocks was because they regarded U.S. financial statements as unreliable.

The principal reason for working with consolidated rather than parent company statements is that losses and liabilities affecting the group may be

hidden in the subsidiaries, and inflated profits and assets included in the parent. (The reverse may also be true.) These possibilities can affect the U.S. data as well as the Japanese, but the transfer of profits to the parent is less likely in the Japanese tax-controlled environment.

The analysis might have been improved by deducting Tanaguchi's investments from total assets and, on the reasonable assumption that they were financed with borrowed money, reducing liabilities accordingly. This would have the primary effect of "purifying" the Tanaguchi data, and a secondary one of producing a better view of its capital structure.

CONFLICTING ACCOUNTING PRINCIPLES

The conflicting accounting principles followed in the two countries is the central theme of the authors of the case, who devote two lengthy appendices to their description. In this section we shall discuss the more relevant differences and the analysts' opinions concerning their effects, but not the manner in which the data were adjusted.

Statement of cash flows. Not provided by Tanaguchi, but in any case, no cash flow ratios were used in the comparison. Japanese corporations have published cash flow forecasts and statements for the past thirty years.

Marketable securities. These were carried by the Japanese at cost, and by the U.S. companies (presumably) at the lower of cost or market. The analysts assumed that the value of Tanaguchi's portfolio would be below cost, so that a conversion to U.S. GAAP would decrease Tanaguchi's net income and total assets, and increase its debt ratio.

Investments in securities. The case points out that U.S. GAAP requires consolidation of greater than 50 percent investees, and equity accounting for 20-50 percent affiliates, whereas Tanaguchi carried both categories at cost. (Again, recall that Tanaguchi's consolidation was available, but not used.) The analysts state that conversion to GAAP would have different effects on net income, total assets, and the debt ratio, depending on whether the subsidiary or affiliate was profitable or not, and the size of its profits or losses. The result would also be affected by the receipt of dividend income from the investees.

Inventories and cost of goods sold. While there is no difference in acceptable accounting principles it was assumed that "most [U.S.] firms use FIFO, LIFO, or a combination of the two." Tanaguchi used weighted average cost. The effects of the cost flow assumption on the U.S. figures are indeterminate, and there is no way of changing Tanaguchi to LIFO, which

it is assumed would decrease its net income and total assets, and increase its debt ratio. The analysts attempted to convert the U.S. data from LIFO to FIFO, using "information provided in the notes for U.S. firms." (But the U.S. data were medians obtained from Robert Morris Associates, not actual data from annual reports.)

Fixed assets and depreciation expense. It was assumed that U.S. companies used straight-line depreciation for financial reporting, and accelerated for tax, and that Tanaguchi used accelerated for both. If so, the analysts concluded, adjusting Tanaguchi would increase its net income and total assets, and decrease its debt ratio. Disregarding the validity of the assumption, it is demonstrable that both methods of depreciation tend toward the same annual expense because of the interaction of new and old equipment costs. Indeed, in Tanaguchi's case, machinery and equipment being almost fully depreciated, we might even expect the opposite to the income effect assumed.

Lease obligations. Tanaguchi treated all leases as operating leases, and whether they are or not depends on the commercial laws of the country. However, a machine tool company is likely to enter into sales-type leases, which might necessitate some deferral of interest revenue otherwise included in gross margin. The analysts were unable to indicate the effect on net income, but assumed that total assets and liabilities would increase.

Deferred taxes. The net effect on Tanaguchi's income of timing differences (which would result largely from the adjustments) was indeterminate. A balance sheet shift from retained earnings to deferred taxation would leave total assets and the debt ratio unaffected. From the comparative viewpoint, the U.S. data are equally uninterpretable, given the confused state of income tax accounting at the time.

Retirement and severance allowance. Tanaguchi accrued "estimated retirement and severance benefits" presumably the difference between the liability at the beginning and end of the year, plus the year's benefits paid. This contrasts with the complex and variable U.S. accounting rules, which in any case do not require the accrual of severance pay. The analysts suggest eliminating this account "since it reflects a different business practice... rather than a different accounting principle" which renders suspect other adjustments to U.S. GAAP. The case makes the point that in Japan such a liability is usually unfunded, but of course the funding for defined benefit plans in the U.S. may be available to management, and is often used for business purposes, sometimes in the form of loans.

As mentioned previously, the net effect of the analysts' adjustments based on their assumptions was to increase Tanaguchi's return on common equity,

primarily a function of the increased leverage assumed, operating margin and asset turnover remaining pretty much the same. (This result is inconsistent with the reported effect on the price/earnings and price/equity ratios, the former declining from 45 to 30.9 and the later from 5.7 to 4.6. These results must reflect a significantly higher net income and a slightly higher common equity.)

THE KEIRETSU AND OTHER "CULTURAL" DIFFERENCES

A major feature of the teaching notes is the attention they draw to cross-cultural factors that must be considered in comparing companies domiciled in different countries. They list economic, business strategy, institutional structure, and cultural norms as areas in which these factors may be observed.

One argument presented by the analysts for interpreting the Japanese ratios differently from the U.S. ratios is that Tanaguchi belonged to a *keiretsu*, a group of affiliated companies in different industries, one of them being a bank. The bank provides the companies with capital in the form of short-term loans and because of its ownership interest is unlikely to allow them to fail when their liquidity declines. It is suggested in the case that this fact should be considered when interpreting Tanaguchi's low acid-test and current ratios and its ratio of short-term debt to total liabilities. However, it is ingenuous to believe that a Japanese bank would suffer losses on a affiliate through slavish adherence to a doctrine of collegiality, and the idea that Japanese firms do not go bankrupt is contradicted by Tanaguchi's allowance for bad debts, amounting to nearly four percent of sales. In the U.S. (and in many other countries) business operations are financed by short-term bank debt that rolls over continually on a cyclical basis, and it is only the increased scrutiny of regulators following the financial excesses of the 1980s that has somewhat diminished this practice.

Another behavioral assumption is that Japanese companies are more concerned with market share than with profitability, and that low reported profits, and consequently zero or low dividends, are acceptable to the other members of the *keiretsu*. This may have been true in respect of dividends, as until 1990 Japanese investors were rewarded through increases in the prices of their shares, a phenomenon related to rising land values. By the same token, however, this assumption leads to the conclusion that the financial statements of a Japanese company are not a useful object of attention by financial analysts, who might be better advised to have a telephone conversation with T. Boone Pickens. Again, to believe that Japanese *corporate* investors (the other members of the *keiretsu*) are indifferent to the profitability of Tanaguchi, or its analysis, also strains credulity.

In fact it is impossible to map cultural differences into a dynamic and changing business environment such as characterizes present-day Japan.

Although in the words of one encyclopedia, "The Japanese have adopted more western (American and European) customs than have any other people in Asia," as Spengler commented seventy years ago, "The best judge of men in the Western world goes wrong when he tries to understand a Japanese, and vice versa" (Spengler 1973, 304).

CONCLUSIONS

The use of the Tanaguchi case to illustrate oversimplification is by no means a criticism of this excellent teaching material. On the contrary, the fact that the above discussion does not rely on specialized knowledge of international accounting, apart from that imparted by the case itself, suggests that the case could be used to discuss oversimplification in any course on financial accounting or accounting theory, whether at the undergraduate or graduate level. One recalls Lee Seidler's assertion that International Accounting is the ultimate theory course.

The interpretation of financial ratios is often the subject of oversimplified conclusions that are not merited by the facts. A ratio is simply an indicator, a flag raised saying "look at me." Differences between ratios should trigger inquiries designed to elucidate them; they are neither good nor bad of themselves. Conventional standards (acid-test ratio 1:1; current ratio 2:1) are of little value. This applies with equal force to trend analysis, interfirm comparisons, and comparisons with industry standards. Use of financial ratios without further inquiry is clearly an indication of defective security analysis.

The belief that a Japanese company's figures can be "improved" for international comparisons by means of adjustments based on assumptions is simplistic. Any attempt to "improve" financial data in order to make them more comparable must be based on research, and not assumptions. This research includes the inquiries suggested by the ratios themselves. Indeed, the assumption that differences between the GAAP used by a selection of U.S. companies will be less marked than their differences from Japanese GAAP is itself a researchable proposition. One of the ways of demonstrating this aspect of the case would be to draw up a table comparing the variety of treatments permitted by U.S. GAAP to the relatively restricted options available to a Japanese company.

Finally, we should beware of assumptions, not based on research, about the effects on accounting and financial reporting of national, ethnic and religious characteristics, or indeed, of any generalizations about such characteristics. We can investigate the alternative hypothesis that the qualities characterizing accountants and auditors are the same everywhere

in the world, and that we are all on the same learning curve, albeit at different points.

Kenneth S. Most
Editor

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