

# CHAPTER 1

## INTRODUCTION TO INTERNATIONAL ACCOUNTING

### Chapter Outline

- I. International accounting is an extremely broad topic.
  - A. At a minimum it focuses on the accounting issues unique to multinational corporations, especially with respect to international transactions and foreign investments.
  - B. At the other extreme it encompasses the study of the various functional areas of accounting in all countries of the world, as well as the activities of a number of supranational organizations.
  - C. This book provides an overview of the broadly defined area of international accounting, including certain supranational guidelines, but focusing on the accounting issues related to international business activities and foreign investments. In other words, this book focuses on international accounting issues at the company level that are specifically relevant to multinational corporations.
- II. There are several accounting issues encountered by companies involved in international trade.
  - A. One issue is the accounting for foreign currency-denominated export sales and import purchases. An important issue is how to account for changes in the value of the foreign currency-denominated account receivable (payable) that occur as exchange rates fluctuate.
  - B. A related issue is the accounting for derivative financial instruments, such as forward contracts and foreign currency options, used to hedge the foreign exchange risk associated with foreign currency transactions.
- III. There is an even greater number of accounting issues encountered by companies that have made a direct investment in a foreign operation. These issues primarily result from the fact that accounting rules, tax laws, and other regulations differ across countries, and include:
  - A. Figuring out how to make sense of the financial statements of a foreign acquisition target prepared in accordance with an unfamiliar GAAP when making a foreign direct investment decision.
  - B. Determining the correct amounts to include in consolidated financial statements for the assets, liabilities, revenues, and expenses of foreign operations. The consolidation of a foreign subsidiary involves a two-step process: (1) restate foreign GAAP financial statements into parent company GAAP and (2) translate foreign currency amounts into parent company currency. Determining the appropriate translation method and deciding how to report the resulting translation adjustment are important questions.
  - C. Complying with host country income tax laws, as well as home country tax laws related to income earned in a foreign country (foreign source income). Double taxation of income is a potential problem, and foreign tax credits are the most important relief from this problem.
  - D. Establishing prices for intercompany transactions that cross national borders (international transfer prices) to achieve corporate objectives and at the same time comply with governmental regulations.

- E. Evaluating the performance of both a foreign operating unit and its management. Decisions must be made with respect to issues such as the currency in which a foreign operation should be evaluated and whether foreign management should be held responsible for items over which they have little control.
  - F. Establishing an effective internal audit function to help maintain control over foreign operations. Differences in culture, customs, and language must be taken into consideration.
  - G. Deciding whether to cross-list securities on foreign stock exchanges, and complying with local stock exchange regulations to do so. This could involve the preparation of financial information in accordance with a GAAP different from that used by the company.
- IV. As companies have become more multinational, so have their external auditors. The Big 4 public accounting firms are among the most multinational business organizations in the world.
- V. Problems encountered by MNCs when confronted with different local GAAP in different countries leads to the desire for a single set of global accounting standards. There would be significant advantages to MNCs if all countries used the same GAAP.
- VI. The world economy is becoming increasingly more integrated. International trade (imports and exports) has grown substantially in recent years and has become a normal part of business for relatively small companies. The number of U.S. exporting companies has increased four-fold over the last three decades.
- VII. The tremendous growth in foreign direct investment (FDI) over the last several decades is partially attributable to the liberalization of investment laws in many countries specifically aimed at attracting FDI. The aggregate revenues generated by foreign operations are more than twice as large as the revenues generated through exporting.
- VIII. There were more than 82,000 multinational companies in the world in 2009 with 810,000 foreign subsidiaries. The 100 largest multinationals generated approximately 4% of global GDP. A disproportionate number of multinational corporations are headquartered in the United States, China, Japan, and the European Union.
- IX. According to one definition of multinationality used by the United Nations, nine of the ten most multinational companies in the world in 2016 were headquartered in Europe, including four companies based in the United Kingdom.
- X. In addition to establishing operations overseas, many companies also cross-list their shares on stock exchanges outside of their home countries. There are a number of reasons for doing this including having access to a larger pool of capital.

## **Answers to Questions**

1. In 2016, companies worldwide exported over \$15.9 trillion worth of merchandise. Although international trade has existed for thousands of years, recent growth in trade has been phenomenal. Over the period 2006-2016, U.S. exports increased from \$1,026 billion to \$1,455 billion per year, a 42% increase. During the same period, Chinese exports more than doubled to \$2,098 billion in 2016.
2. Companies engaged in international trade with imports and exports denominated in foreign currencies are faced with the accounting issue of translating foreign currency amounts into the company's reporting currency and reporting the effects of changes in exchange rates in the financial statements. Many of these companies also engage in hedging activities to reduce the risk of changes in exchange rates. The accounting for derivative financial instruments used to hedge foreign exchange risk can be quite complicated.
3. As listed in Exhibit 1-1, following are several reasons why companies might want to invest overseas:
  - Increase sales and profits
  - Enter rapidly growing or emerging markets
  - Reduce costs
  - Gain an foothold in economic blocs
  - Protect domestic markets
  - Protect foreign markets
  - Acquire technological and managerial know-how
4. FDI is playing a larger and more important role in the world economy. Global sales of foreign affiliates were more than twice as large as global exports in 2016, compared to almost parity about three decades earlier. Global sales of foreign affiliates comprise about one half of worldwide gross domestic product.
5. Financial reporting issues that result from foreign direct investment are (a) conversion of foreign GAAP to parent company GAAP and (b) translation of foreign currency to parent company reporting currency to prepare consolidated financial statements.
6. Two major taxation issues related to a foreign direct investment are (a) taxation of the investee's income by the host country in which the investment is located and (b) taxation of the investee's income by the investor's home country. Companies with foreign direct investments need to develop an expertise in the host country's income tax rules, as well as in the home country's tax rules with respect to foreign source income.
7. Companies must make several decisions in designing the system for evaluating the performance of foreign operations. Two of these are (a) deciding whether to evaluate performance on the basis of foreign currency or parent company reporting currency and (b) deciding whether to factor out of the performance measure those items over which the foreign operation's managers have no control.
8. Two reasons to have stock listed on the stock exchange of a foreign country are (a) to obtain capital in that country, perhaps at a more reasonable cost than is available at home, and (b) to have an "acquisition currency" for acquiring firms in that country through stock swaps.

9. The United Nations measures the multinationality of companies based on the average of three factors: the ratio of foreign sales to total sales, the ratio of foreign assets to total assets, and the ratio of foreign employees to total employees. Information about foreign sales and foreign assets generally is provided in a company's annual report. Information about the number of foreign employees also might be provided in the annual report or other publications through which a company provides information to the public.
10. A single set of accounting standards used worldwide would have the following benefits for multinational corporations:
  - Reduce the cost of preparing consolidated financial statements
  - Reduce the cost of gaining access to capital in foreign countries
  - Facilitate the analysis and comparison of financial statements of competitors and potential acquisitions

## **Solutions to Exercises and Problems**

1. Sony uses the following procedures to translate the foreign currency financial statements of its foreign subsidiaries into Japanese yen:
  - All assets and liabilities are translated at the year-end exchange rate
  - All income and expense accounts are translated at the exchange rate prevailing on the transaction date
  - The resulting translation adjustment is included in accumulated other comprehensive income (stockholders' equity)

Sony uses the following procedure to translate foreign currency payables and receivables into Japanese yen:

- All foreign currency receivables and payables are translated into Japanese yen at the year-end exchange rate
  - Changes in the Japanese yen value of foreign currency receivables and payables are reported as gains and losses in income
2. a. The BRL pre-tax income becomes a USD pre-tax loss because Sales and Expenses are translated at different exchange rates. Specifically, Sales are translated at an exchange rate of USD 0.30 per 1 BRL [USD 3,000 / BRL 10,000] and Expenses are translated at an exchange rate of USD 0.347368 per 1 BRL [USD 3,300 / BRL 9,500].  
  
b. The question is whether Acme Brush should use BRL income or USD income to evaluate Cooper Grant's performance. There is no unequivocally correct answer to this question. Issues that might be discussed include:
    - What is the Brazilian subsidiary's objective? To generate profits that can be distributed to U.S. stockholders?
    - Does Cooper Grant have the ability to "control" USD income, for example, by hedging against changes in the USD per BRL exchange rate?
    - Do the translation procedures that result in a USD pre-tax loss make economic sense?

3. The New York Stock Exchange (NYSE) provides a PDF file titled "Current List of All Non-U.S. Issuers" on its website ([www.nyse.com](http://www.nyse.com)). This document can be accessed either by using a web browser to search for "NYSE Current List of All Non-U.S. Issuers" or by searching within the NYSE website.

**Note: The answers to a. and b. provided below were as of September 30, 2017. The instructor should update these answers to the current date.**

- a. A total of 490 non-U.S. companies from 46 different countries were listed on the NYSE.
- b. The foreign countries with the most companies listed on the NYSE were: Canada (135); China (61); U.K. (36); Brazil (29); and Bermuda (22).
- c. Companies in Canada, China, Brazil, and Bermuda probably have listed on the NYSE to tap into the much larger U.S. capital market. The reasons for U.K. companies to list on the NYSE are less clear. One reason a foreign company might want to list its shares in the United States is to enhance the company's ability to acquire U.S. companies through an exchange of shares of stock. U.S. stockholders are more likely to trade in their shares of stock in a U.S. company in exchange for shares of a foreign company if that foreign company's shares are traded on a U.S. stock exchange.

4. The London Stock Exchange (LSE) provides an Excel file containing a list of all companies listed on the exchange on its website ([www.londonstockexchange.com](http://www.londonstockexchange.com)). In 2018, this could be found under “Statistics” and then “Companies and Securities” on the LSE website.

**Note: The answers below come from an Excel spreadsheet “Companies on London Stock Exchange – As at 31 January 2018.” The instructor should update these answers to the current date.**

- a. The Excel spreadsheet lists 523 non-U.K. companies. These companies represent 39 different countries.
- b. Australia (25), Brazil (0), Canada (16), China (3), France (2), Germany (4), Mexico (0), and the United States (18). Four reasons why there are more companies listed on the LSE from Australia and Canada than from France and Germany might be:
  - Language – the LSE might require information filed with it to be in English, a requirement easier for Australian and Canadian companies to meet.
  - Number of publicly traded companies – even though there are more people in France and Germany, there might be more publicly traded companies in Canada and Australia. The percentage of publicly traded companies listed on the LSE might actually be the same across the four countries. For example, 16 Canadian companies might be the same percentage of total publicly traded companies in Canada as is 4 companies in Germany.
  - Size of local capital market – large firms in France and Germany might have no problem obtaining sufficient capital locally; Australia and Canada might have relatively small capital markets and large companies might need to obtain financing in international markets.

5. Based on the geographical distribution of Sales Revenues from External Customers (Revenue) and Intangible Assets, PPE, Leased Assets and Investment Property (Non-current Assets), Volkswagen has a multinationality index (MNI) of 0.63 and Daimler has a multinationality index of 0.68.

(Neither company provides information on the geographical distribution of employees in the annual report.)

**Volkswagen AG**  
**2016 Annual Report**

<i>In millions of euros</i>	<b>Sales revenue from external customers</b>	<b>Intangible assets, property, plant and equipment, lease assets and investment property</b>	<b>Multinationality Index (MNI)</b>
Germany	43,634	84,525	
Europe/Other markets	94,445	40,717	
North America	35,454	23,958	
South America	7,973	3,320	
Asia-Pacific	35,761	3,064	
Total	<u>217,267</u>	<u>155,583</u>	
Foreign	173,633	71,058	
Foreign/Total %	79.91%	45.67%	62.79%
			<b>0.63</b>

**Daimler AG**  
**2016 Annual Report**

<i>In millions of euros</i>	<b>Revenue</b>	<b>Non-current Assets</b>	<b>Multinationality Index (MNI)</b>
Europe	63,417	45,565	
thereof Germany	23,509	34,981	
NAFTA region	44,960	24,105	
thereof United States	39,169	21,878	
Asia	35,562	2,161	
thereof China	15,984	100	
Other markets	9,322	1,502	
Total	<u>153,261</u>	<u>73,333</u>	
Foreign	129,752	38,352	
Foreign/Total %	84.66%	52.30%	68.48%
			<b>0.68</b>

### **Case 1-1: Besserbrau AG**

Besserbrau AG is faced with international accounting issues related to four different types of activities:

1. International Trade: Imports from Czech Republic; exports to China
  - Translation of foreign currency payables and receivable resulting from import and export transactions
  - Account for foreign currency forward contracts and foreign currency options used to hedge foreign exchange risk related to foreign currency payables and receivables
2. Foreign direct investment in China
  - Conversion of BB Pijio's profit from Chinese GAAP to German GAAP
  - Translation of BB Pijio's profit from Chinese currency (renminbi) to German currency (euro)
  - Chinese taxation of income earned in China
  - German taxation of income earned in China
  - Evaluation of BB Pijio's performance
3. Pricing of intercompany sales made by Besserbrau (Germany) to BB Pijio (China)
  - Compliance with German and Chinese transfer pricing regulations
4. Cross-listing on London Stock Exchange
  - Compliance with London Stock Exchange financial reporting requirements

### **Case 1-2: Vanguard International Growth Fund**

1. Individual investors can diversify the risk associated with investing in companies in only one country by investing in mutual funds that invest in the stock of foreign companies.
2. According to information provided in the fund's prospectus, the International Growth Fund is subject to:
  - Investment style risk, which is the chance that returns from the types of stocks in which it invests will trail returns from the global stock markets.
  - Stock market risk, which is the chance that stock prices overall will decline.
  - Country/regional risk, which is the chance that world events—such as political upheaval, financial troubles, or natural disasters—will adversely affect the value of securities issued by companies in foreign countries or regions.
  - Currency risk, which is the chance that the value of a foreign investment, in terms of U.S. dollars, will decrease because of unfavorable changes in currency.
  - Manager risk, which is the chance that poor security selection will cause the fund to underperform relevant benchmarks.

Investment style, stock market, and manager risks are common to both domestic and international funds. International funds are also subject to country/regional and currency risks.



**Case 1-2 (continued)**

3. The “Plain Talk About International Investing” box suggests that the fact that foreign companies are not subject to the same accounting, auditing, and financial reporting standards and practices as U.S. companies could negatively affect the returns U.S. investors receive from foreign investments. Because foreign companies are not subject to the same standards as U.S. companies, there exists a risk that the financial information made available by foreign companies is not as useful nor as reliable in making investment decisions as information provided by U.S. companies. The quality of accounting and financial reporting standards can affect the usefulness of financial information and the quality of auditing practices can affect that information’s reliability. The risk that investing in foreign companies is based on information that is potentially less useful and less reliable could adversely impact the returns generated from those investments.
4. The fund’s assets are distributed by region as follows: Europe (47.5%), Emerging Markets (22.2%), Pacific (19.5%), North America (9.0%), and Middle East (1.8%). Other than North America, this allocation might be affected by (a) the number of firms listed on stock exchanges in those regions, (b) relative risks—country and currency—across regions, (c) relative growth potentials across regions, and/or (d) differences in the quality and quantity of information provided by companies for making investment decisions.
5. The fund is most heavily invested in China (16.2%), Japan (12.2%), United Kingdom (11.4%), Germany (9.2%), and United States (7.2%). The reasons why these countries are so heavily represented are similar to those listed in 4 above.

One might have expected more investment in emerging markets like Brazil and India. Also, one might expect the percentage invested in the France and Germany to be more similar.

The fund has a very small amount of investment in Canadian companies, and apparently nothing in Mexican companies. One might have expected more investment in companies located in these countries.

6. The fund is most heavily invested in the following sectors: Information Technology (22.4%), Consumer Discretionary (21.8%), and Financials (17.3%). These industries might be the most profitable or have the highest growth potential. As a regulated industry, financials might be perceived as being subject to more oversight and providing more reliable information for making investment decisions than other sectors.