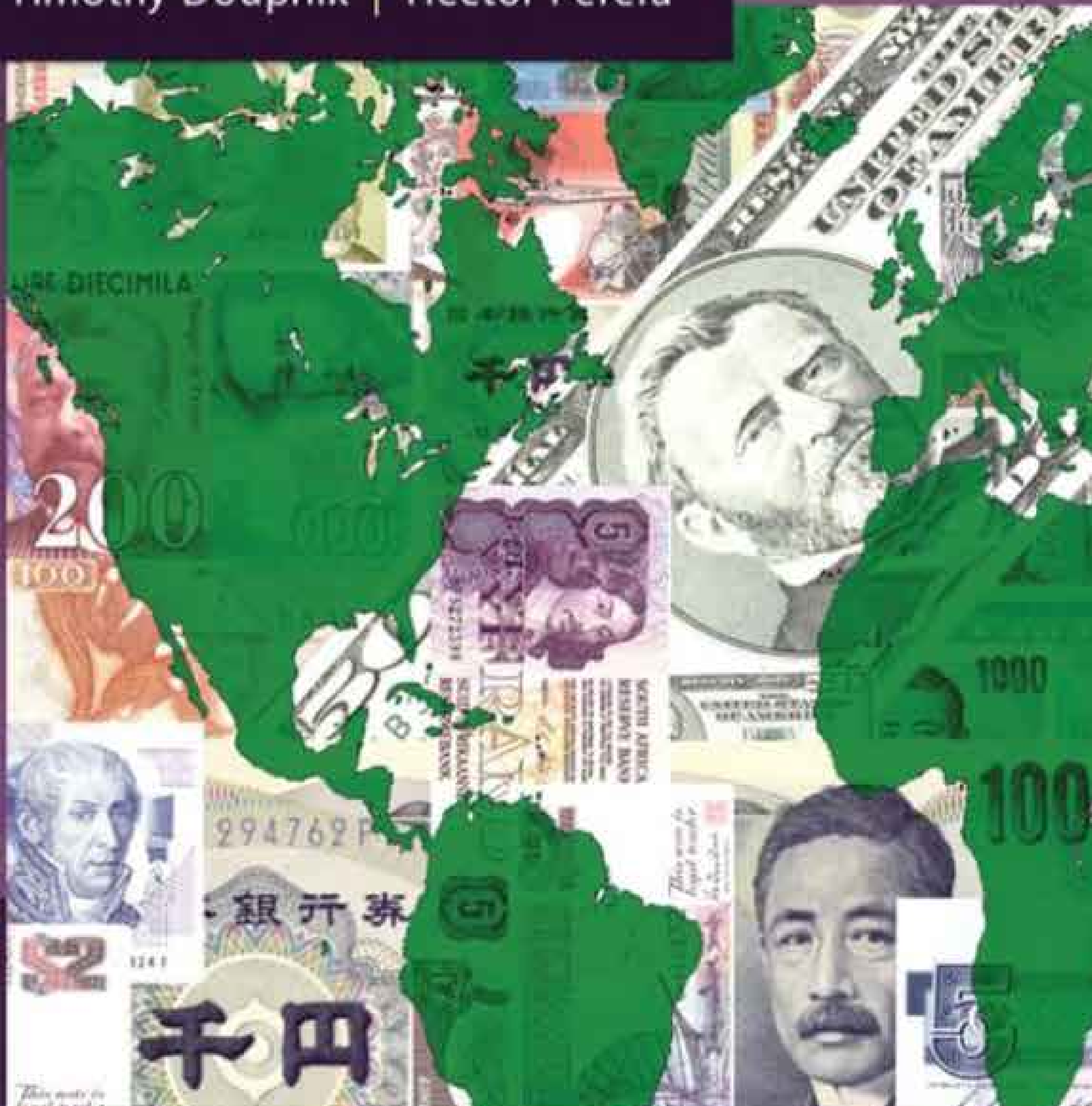
Timothy Doupnik | Hector Perera



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International Accounting

International Accounting

Fourth Edition

Timothy Doupnik
University of South Carolina

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McGraw Hill Education

INTERNATIONAL ACCOUNTING, FOURTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QVS/QVS 1 0 9 8 7 6 5 4

ISBN 978-0-07-786220-6
MHID 0-07-786220-1

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Cover Designer: *Studio Montage, St. Louis, MO.*
Cover Image: *Brand X Pictures*
Compositor: *MPS Limited*
Typeface: *10/12 Palatino*
Printer: *Quad/Graphics*

Library of Congress Cataloging-in-Publication Data

Doupnik, Timothy S.
International accounting / Timothy Doupnik, University of South Carolina, Hector Perera, Macquarie University.—Fourth Edition.
pages cm
Includes bibliographical references and index.
ISBN 978-0-07-786220-6 (alk. paper)
1. Accounting. 2. International business enterprises—Accounting. 3. Foreign exchange—Accounting. I. Perera, M. H. B. II. Title.
HF5636.D68 2014
657'.96—dc23 2013039346

www.mhhe.com

To my wife, Birgit, and children, Stephanie and Alexander

—TSD

To my wife, Sujatha, and daughter, Hasanka

—HBP

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Timothy S. Doupnik is a Professor of Accounting at the University of South Carolina, where he has been on the faculty since 1982, and primarily teaches financial and international accounting. He served as director of the School of Accounting from 2003 until 2010, and then as Vice Provost for international affairs until 2013. He has an undergraduate degree from California State University–Fullerton, and received his master's and Ph.D. from the University of Illinois.

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Professor Doupnik is a past president of the International Accounting Section of the American Accounting Association, and he received the section's Outstanding International Accounting Educator Award in 2008. He has taught or conducted research in the area of international accounting at universities in a number of countries around the world, including Brazil, China, Dominican Republic, Finland, Germany, and Mexico.

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Professor Perera served as chair of the International Relations Committee of the American Accounting Association's International Accounting Section in 2003 and 2004. He was an associate editor for the *Journal of International Accounting Research* and on the editorial boards of *Accounting Horizons* and *Pacific Accounting Review*. Currently, he is on the editorial boards of *Review of Accounting and Finance; International Journal of Accounting, Auditing and Performance Evaluation;* and *Qualitative Research in Accounting and Management*.

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Preface

ORIENTATION AND UNIQUE FEATURES

International accounting can be viewed in terms of the accounting issues uniquely confronted by companies involved in international business. It also can be viewed more broadly as the study of how accounting is practiced in each and every country around the world, learning about and comparing the differences in financial reporting, taxation, and other accounting practices that exist across countries. More recently, international accounting has come to be viewed as the study of rules and regulations issued by international organizations—most notably International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). This book is designed to be used in a course that attempts to provide an overview of the broadly defined area of international accounting, but that focuses on the accounting issues related to international business activities and foreign operations and provides substantial coverage of the IASB and IFRS.

The unique benefits of this textbook include its up-to-date coverage of relevant material; extensive numerical examples provided in most chapters; two chapters devoted to the application of International Financial Reporting Standards (IFRS); and coverage of nontraditional but important topics such as strategic accounting issues of multinational companies, international corporate governance, and corporate social reporting. This book contains several important distinguishing features:

- Numerous excerpts from recent annual reports to demonstrate differences in financial reporting practices across countries and to demonstrate financial reporting issues especially relevant for multinational corporations.
- Incorporation of research findings into the discussion on many issues.
- Extensive end-of-chapter assignments that help students develop their analytical, communication, and research skills.
- Detailed discussion on the most recent developments in the area of international harmonization/convergence of financial reporting standards.
- Two chapters on International Financial Reporting Standards that provide detailed coverage of a wide range of standards and topics. One chapter focuses on the financial reporting of assets, and the second chapter focuses on liabilities, financial instruments, and revenue recognition. (IFRS related to topics such as business combinations, foreign currency, and segment reporting are covered in other chapters.) The IFRS chapters also include numerical examples demonstrating major differences between IFRS and U.S. GAAP and their implications for financial statements.
- Separate chapters for foreign currency transactions and hedging foreign exchange risk and translation of foreign currency financial statements. The first of these chapters includes detailed examples demonstrating the accounting for foreign currency derivatives used to hedge a variety of types of foreign currency exposure.
- Separate chapters for international taxation and international transfer pricing, with detailed examples based on provisions in U.S. tax law.

- A chapter devoted to a discussion of the strategic accounting issues facing multinational corporations, with a focus on the role accounting plays in strategy formulation and implementation.
- Use of a corporate governance framework to cover external and internal auditing issues in an international context, with substantial coverage of the Sarbanes-Oxley Act of 2002.
- A chapter on corporate social responsibility reporting, which is becoming increasingly more common among global enterprises.

CHAPTER-BY-CHAPTER CONTENT

Chapter 1 introduces the accounting issues related to international business by following the evolution of a fictional company as it grows from a domestic company to a global enterprise. This chapter provides the context into which the topics covered in the remaining chapters can be placed.

Chapters 2 and 3 focus on differences in financial reporting across countries and the international convergence of accounting standards.

- Chapter 2 presents evidence of the diversity in financial reporting that exists around the world, explores the reasons for that diversity, and describes the problems that are created by differences in accounting practice across countries. In this chapter, we also describe and compare several major models of accounting used internationally. We discuss the potential impact that culture has on the development of national accounting systems and present a simplified model of the reasons for international differences in financial reporting. The final section of this chapter uses excerpts from recent annual reports to present additional examples of some of the differences in accounting that exist across countries.
- Chapter 3 focuses on the major efforts worldwide to converge financial reporting practices, with an emphasis on the activities of the International Accounting Standards Board (IASB). We explain the meaning of convergence, identify the arguments for and against convergence, and discuss the use of the IASB's International Financial Reporting Standards (IFRS), including national efforts to converge with those standards.

The almost universal recognition of IFRS as a high-quality set of global accounting standards is arguably the most important development in the world of international accounting. Chapters 4 and 5 introduce financial reporting under IFRS for a wide range of accounting issues.

- Chapter 4 summarizes the major differences between IFRS and U.S. GAAP. It provides detailed information on selected IFRS, concentrating on standards that relate to the recognition and measurement of assets—including inventories; property, plant, and equipment; intangible assets; and leased assets. Numerical examples demonstrate the application of IFRS, differences between IFRS and U.S. GAAP, and the implications for financial statements. This chapter also describes the requirements of IFRS in a variety of disclosure and presentation standards.
- Chapter 5 focuses on current liabilities, provisions, employee benefits, share-based payment, income taxes, revenue, and financial instruments, including major differences between IFRS and U.S. GAAP.

Chapter 6 describes the accounting environment in five economically significant countries—China, Germany, Japan, Mexico, and the United Kingdom—that are representative of major clusters of accounting systems. The discussion related to each country's accounting system is organized into four parts: background, accounting profession, accounting regulation, and accounting principles and practices. Exhibits throughout the chapter provide detailed information on differences between each country's GAAP and IFRS, as well as reconciliations from local GAAP to U.S. GAAP.

Chapters 7, 8, and 9 deal with financial reporting issues that are of particular importance to multinational corporations. Two different surveys of business executives indicate that the most important topics that should be covered in an international accounting course are related to the accounting for foreign currency.[1] Because of its importance, this topic is covered in two separate chapters (Chapters 7 and 8). Chapter 9 covers three additional financial reporting topics of particular importance to multinational corporations—inflation accounting, business combinations and consolidated financial statements, and segment reporting. Emphasis is placed on understanding IFRS related to these topics.

- Chapter 7 begins with a description of the foreign exchange market and then demonstrates the accounting for foreign currency transactions. Much of this chapter deals with the accounting for derivatives used in foreign currency hedging activities. We first describe how foreign currency forward contracts and foreign currency options can be used to hedge foreign exchange risk. We then explain the concepts of cash flow hedges, fair value hedges, and hedge accounting. Finally, we demonstrate the accounting for forward contracts and options used as cash flow hedges and fair value hedges to hedge foreign currency assets and liabilities, foreign currency firm commitments, and forecasted foreign currency transactions.
- Chapter 8 focuses on the translation of foreign currency financial statements for the purpose of preparing consolidated financial statements. We begin by examining the conceptual issues related to translation, focusing on the concept of balance sheet exposure and the economic interpretability of the translation adjustment. Only after a thorough discussion of the concepts and issues do we then describe the manner in which these issues have been addressed by the IASB and by the U.S. FASB. We then illustrate application of the two methods prescribed by both standard-setters and compare the results. We discuss the hedging of balance sheet exposure and provide examples of disclosures related to translation.
- Chapter 9 covers three additional financial reporting issues. The section on inflation accounting begins with a conceptual discussion of asset valuation and capital maintenance through the use of a simple numerical example and then summarizes the inflation accounting methods used in different countries. The second section focuses on International Financial Reporting Standards related to business combinations and consolidations, covering issues such as

[1] T. Conover, S. Salter, and J. Price, "International Accounting Education: A Comparison of Course Syllabi and CFO Preferences," *Issues in Accounting Education,* Volume 9, Issue 2, Fall 1994; and T. Foroughi and B. Reed, "A Survey of the Present and Desirable International Accounting Topics in Accounting Education," *International Journal of Accounting,* Volume 23, Number 1, Fall 1987, pp. 64–82.

the determination of control, the acquisition method, proportionate consolidation, and the equity method. The final section of this chapter focuses on International Financial Reporting Standard 8, *Operating Segments.*

Chapter 10 introduces issues related to the analysis of foreign financial statements. We explore potential problems (and possible solutions to those problems) associated with using the financial statements of foreign companies for decision-making purposes. This chapter also provides an example of how an analyst would reformat and restate financial statements from one set of GAAP to another.

Business executives rank international taxation second only to foreign currency in importance as a topic to be covered in an international accounting course.[2] International taxation and tax issues related to international transfer pricing are covered in Chapters 11 and 12.

- Chapter 11 focuses on the taxation of foreign operation income by the home-country government. Much of this chapter deals with foreign tax credits, the most important mechanism available to companies to reduce double taxation. This chapter provides a comprehensive example demonstrating the major issues involved in U.S. taxation of foreign operation income. We also discuss benefits of tax treaties, translation of foreign currency amounts for tax purposes, and tax incentives provided to attract foreign investment.
- Chapter 12 covers the topic of international transfer pricing, focusing on tax implications. We explain how discretionary transfer pricing can be used to achieve specific cost minimization objectives and how the objectives of performance evaluation and cost minimization can conflict in determining international transfer prices. We also describe government reactions to the use of discretionary transfer pricing by multinational companies, focusing on the U.S. rules governing intercompany pricing.

Chapter 13 covers strategic accounting issues of particular relevance to multinational corporations. This chapter discusses multinational capital budgeting as a vital component of strategy formulation and operational budgeting as a key ingredient in strategy implementation. Chapter 13 also deals with issues that must be addressed in designing a process for evaluating the performance of foreign operations.

Chapter 14 covers comparative international auditing and corporate governance. This chapter discusses both external and internal auditing issues as they relate to corporate governance in an international context. Chapter 14 also describes international diversity in external auditing and the international harmonization of auditing standards.

Chapter 15 introduces the current trend toward corporate social reporting (CSR) by multinational corporations (MNCs). We describe theories often used to explain CSR practices by companies and the motivations for them to engage in CSR practices. We also examine the implications of climate change for CSR. Further, we discuss some issues associated with regulation of CSR at the international level and identify international organizations that promote CSR, such as Global Reporting Initiative (GRI). Finally, we provide examples of actual CSR practices by MNCs.

[2] Ibid.

CHANGES IN THE FOURTH EDITION

Chapter 1

- Updated statistics provided in the section titled "The Global Economy"
- Updated End-of-Chapter (EOC) assignments based on annual reports and other dated material to the most current information available

Chapter 2

- Noted that inflation is no longer as important in explaining accounting diversity as it once was and that European accountants need to develop an expertise in both local GAAP and IFRS

Chapter 3

- Updated exhibits on excerpts from annual reports of various companies
- Added two new sections at the end of the chapter titled "Challenges to International Convergence of Financial Reporting Standards" and "New Direction to the IASB"
- Added three new Exercises and Problems to the EOC material

Chapter 4

- Noted that the discussion in the section on "Leases" is based on guidance in effect at the time of publication, and that a revised IASB-FASB exposure draft issued in 2013 was likely to substantially change and converge lease accounting at some unknown future date

Chapter 5

- Deleted the subsection on "Proposed Amendments to IAS 37"
- Rewrote the subsection on "Post-Employment Benefits" to reflect the new guidance provided in IAS 19 (Revised), which was issued in 2011
- Rewrote several Exercises and Problems in the EOC material related to post-employment benefits to reflect the changes in IAS 19 (Revised)
- Deleted the subsection on "Termination Benefits"
- Removed reference to a 2009 IASB Exposure Draft from the section on "Income Taxes"
- In the subsection titled "IASB-FASB Revenue Recognition Project," removed some of the specific discussion and an example based upon the 2011 IASB-FASB joint Exposure Draft, and noted that a new standard, if approved, would not become effective any earlier than 2017

Chapter 6

- Updated annual report excerpts
- Added new material incorporating the latest developments with regard to financial reporting in China, Germany, Japan, Mexico, and the United Kingdom
- Added three new Questions and one new Exercise and Problem to the EOC material

Chapter 7

- Updated annual report excerpts and the related discussion
- Updated Exhibit 7.1 to provide recent exchange rates and the related discussion

- Enhanced explanation of several journal entries related to the accounting for a "Forward Contract Designated as Cash Flow Hedge"
- Deleted the subsection titled "The Euro"
- Updated Case 7-2 to be based on more recent exchange rates

Chapter 8

- Updated annual report excerpts and the related discussion
- Updated the U.S dollar-to-euro exchange rates used in the example provided in "Translation Process Illustrated" to more current levels

Chapter 9

- Updated annual report excerpts and the related discussion
- Added a subsection on "Identification of Highly Inflationary Countries"
- Deleted the subsection on "Proportionate Consolidation" and removed the requirements in EOC Exercise and Problem 6 related to proportionate consolidation
- Added discussion of IFRS 11 in the section titled "Equity Method"
- Updated EOC Exercise and Problem 10 to be based on the most current annual report disclosures available

Chapter 10

- Deleted the discussion related to leases in the subsection titled "Extent of Disclosure"

Chapter 11

- Updated information in several Exhibits providing income, withholding, and treaty tax rates and updated Case 11-1 to reflect changes in these rates

Chapter 12

- Updated statistics related to the extent of international intercompany transfers, the use of various transfer pricing methods, the use of advance pricing agreements, and the enforcement of transfer pricing regulations

Chapter 13

- Replaced Exhibit 13.14, "Rockwater's Balanced Scorecard," with "Use of Balanced Scorecard at Veolia Water"
- Revamped Case 13-2, Lion Nathan Limited, in the EOC material

Chapter 14

- Updated Exhibits 14.5 and 14.6, and "Appendix to Chapter 14" on excerpts from annual reports of various companies.

Chapter 15

- Added new material incorporating GRI's fourth-generation guidelines issued in 2013
- Updated Exhibits 15.4, 15.5, and 15.6
- Added a new Case 15-1, Modco Inc., to the EOC material

SUPPLEMENTARY MATERIAL

International Accounting is accompanied by supplementary items for both students and instructors. The Online Learning Center (www.mhhe.com/doupnik4e) is a book-specific website that includes the following supplementary materials.

For Students:

- PowerPoint Presentation

For Instructors:

- Access to all supplementary materials for students
- Instructor's Manual
- PowerPoint Presentation
- Test Bank

Acknowledgments

We want to thank the many people who participated in the review process and offered their helpful comments and suggestions:

Wagdy Abdallah
Seton Hall University

Kristine Brands
Regis University

Bradley Childs
Belmont University

Teresa Conover
University of North Texas

Orapin Duangploy
University of Houston–Downtown

Gertrude Eguae-Obazee
Albright College

Emmanuel Emmenyonu
Southern Connecticut State University

Charles Fazzi
Saint Vincent College

Mark Finn
Northwestern University

Leslie B. Fletcher
Georgia Southern University

Paul Foote
California State University–Fullerton

Mohamed Gaber
State University of New York at Plattsburgh

Giorgio Gotti
University of Massachusetts–Boston

Shiv Goyal
University of Maryland University College

Robert Gruber
University of Wisconsin

Marianne James
California State University–Los Angeles

Cynthia Jeffrey
Iowa State University

Craig Keller
Missouri State University

Victoria Krivogorsky
San Diego State University

Britton McKay
Georgia Southern University

Jamshed Mistry
Suffolk University

Gregory Naples
Marquette University

Cynthia Nye
Bellevue University

Randon C. Otte
Clarion University

Obeua Persons
Rider University

Felix Pomeranz
Florida International University

Grace Pownall
Emory University

Juan Rivera
University of Notre Dame

Kurt Schulzke
Kennesaw State University

Mary Sykes
University of Houston–Downtown

We are also thankful to Gary Blumenthal, chief financial officer of The Forbes Consulting Group and instructor at Stonehill College, who revised the PowerPoint slides and Test Bank to accompany the third edition of the text.

We also pass along many thanks to all the McGraw-Hill Education who participated in the creation of this book. In particular, Executive Brand Manager James Heine, Development Editor Gail Korosa, and Senior Marketing Manager Kathleen Klehr.

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Chapter One

Introduction to International Accounting

Learning Objectives

After reading this chapter, you should be able to

- Discuss the nature and scope of international accounting.
- Describe accounting issues confronted by companies involved in international trade (import and export transactions).
- Explain the reasons for, and the accounting issues associated with, foreign direct investment.
- Describe the practice of cross-listing on foreign stock exchanges.
- Explain the notion of global accounting standards.
- Examine the importance of international trade, foreign direct investment, and multinational corporations in the global economy.

WHAT IS INTERNATIONAL ACCOUNTING?

Most accounting students are familiar with financial accounting and managerial accounting, but many have only a vague idea of what international accounting is. Defined broadly, the *accounting* in international accounting encompasses the functional areas of financial accounting, managerial accounting, auditing, taxation, and accounting information systems.

The word *international* in international accounting can be defined at three different levels.[1] The first level is supranational accounting, which denotes standards, guidelines, and rules of accounting, auditing, and taxation issued by supranational organizations. Such organizations include the United Nations, the Organization for Economic Cooperation and Development, and the International Federation of Accountants.

[1] This framework for defining international accounting was developed by Professor Konrad Kubin in the preface to *International Accounting Bibliography 1982–1994,* distributed by the International Accounting Section of the American Accounting Association (Sarasota, FL: AAA, 1997).

At the second level, the company level, international accounting can be viewed in terms of the standards, guidelines, and practices that a company follows related to its international business activities and foreign investments. These would include standards for accounting for transactions denominated in a foreign currency and techniques for evaluating the performance of foreign operations.

At the third and broadest level, international accounting can be viewed as the study of the standards, guidelines, and rules of accounting, auditing, and taxation that exist within each country as well as comparison of those items across countries. Examples would be cross-country comparisons of (1) rules related to the financial reporting of plant, property, and equipment; (2) income and other tax rates; and (3) the requirements for becoming a member of the national accounting profession.

Clearly, international accounting encompasses an enormous amount of territory—both geographically and topically. It is not feasible or desirable to cover the entire discipline in one course, so an instructor must determine the scope of an international accounting course. This book is designed to be used in a course that attempts to provide an overview of the broadly defined area of international accounting, but that also focuses on the accounting issues related to international business activities and foreign operations.

EVOLUTION OF A MULTINATIONAL CORPORATION

To gain an appreciation for the accounting issues related to international business, let us follow the evolution of Magnum Corporation, a fictional auto parts manufacturer headquartered in Detroit, Michigan.[2] Magnum was founded in the early 1950s to produce and sell rearview mirrors to automakers in the United States. For the first several decades, all of Magnum's transactions occurred in the United States. Raw materials and machinery and equipment were purchased from suppliers located across the United States, finished products were sold to U.S. automakers, loans were obtained from banks in Michigan and Illinois, and the common stock was sold on the New York Stock Exchange. At this stage, all of Magnum's business activities were carried out in U.S. dollars, its financial reporting was done in compliance with U.S. generally accepted accounting principles (GAAP), and taxes were paid to the U.S. federal government and the state of Michigan.

Sales to Foreign Customers

In the 1980s, one of Magnum's major customers, Normal Motors Inc., acquired a production facility in the United Kingdom, and Magnum was asked to supply this operation with rearview mirrors. The most feasible means of supplying Normal Motors UK (NMUK) was to manufacture the mirrors in Michigan and then ship them to the United Kingdom, thus making export sales to a foreign customer. If the sales had been invoiced in U.S. dollars, accounting for the export sales would have been no different from accounting for domestic sales. However, Normal Motors required Magnum to bill the sales to NMUK in British pounds (£), thus creating foreign currency sales for Magnum. The first shipment of mirrors to NMUK was

[2] The description of Magnum's evolution is developed from a U.S. perspective. However, the international accounting issues that Magnum is forced to address would be equally applicable to a company headquartered in any other country in the world.

invoiced at £100,000 with credit terms of 2/10, net 30. If Magnum were a British company, the journal entry to record this sale would have been:

Dr. Accounts Receivable (+ Assets)	£100,000	
Cr. Sales Revenue (+ Equity)		£100,000

However, Magnum is a U.S.-based company that keeps its accounting records in U.S. dollars (US$). To account for this export sale, the British pound sale and receivable must be translated into US$. Assuming that the exchange rate between the £ and the US$ at the time of this transaction was £1 = US$1.60, the journal entry would have been:

Dr. Accounts Receivable (£) (+ Assets)	US$160,000	
Cr. Sales Revenue (+ Equity)		US$160,000

This was the first time since its formation that Magnum had found it necessary to account for a transaction denominated (invoiced) in a currency other than the U.S. dollar. The company added to its chart of accounts a new account indicating that the receivable was in a foreign currency, "Accounts Receivable (£)," and the accountant had to determine the appropriate exchange rate to translate £ into US$.

As luck would have it, by the time NMUK paid its account to Magnum, the value of the £ had fallen to £1 = US$1.50, and the £100,000 received by Magnum was converted into US$150,000. The partial journal entry to record this would have been:

Dr. Cash (+ Asset)	US$150,000	
Cr. Accounts Receivable (£) (– Asset)		US$160,000

This journal entry is obviously incomplete because the debit and the credit are not equal and the balance sheet will be out of balance. A question arises: How should the difference of US$10,000 between the original US$ value of the receivable and the actual number of US$ received be reflected in the accounting records? Two possible answers would be (1) to treat the difference as a reduction in sales revenue or (2) to record the difference as a separate loss resulting from a change in the foreign exchange rate. This is an accounting issue that Magnum was not required to deal with until it became involved in export sales. Specific rules for accounting for foreign currency transactions exist in the United States, and Magnum's accountants had to develop an ability to apply those rules.

Through the British-pound account receivable, Magnum became exposed to foreign exchange risk—the risk that the foreign currency will decrease in US$ value over the life of the receivable. The obvious way to avoid this risk is to require foreign customers to pay for their purchases in US$. Sometimes foreign customers will not or cannot pay in the seller's currency, and to make the sale, the seller will be obliged to accept payment in the foreign currency. Thus, foreign exchange risk will arise.

Hedges of Foreign Exchange Risk

Companies can use a variety of techniques to manage, or hedge, their exposure to foreign exchange risk. A popular way to hedge foreign exchange risk is through the purchase of a foreign currency option that gives the option owner the right, but not the obligation, to sell foreign currency at a predetermined exchange rate known as the strike price. Magnum purchased such an option for US$200 and was able to sell the £100,000 it received for a total of US$155,000 because of the option's strike price. The foreign currency option was an asset that Magnum was required to account for over its 30-day life. Options are a type of derivative financial instrument,[3] the accounting for which can be quite complicated. Foreign currency forward contracts are another example of derivative financial instruments commonly used to hedge foreign exchange risk. Magnum never had to worry about how to account for hedging instruments such as options and forward contracts until it became involved in international trade.

Foreign Direct Investment

Although the managers at Magnum at first were apprehensive about international business transactions, they soon discovered that foreign sales were a good way to grow revenues and, with careful management of foreign currency risk, would allow the company to earn adequate profit. Over time, Magnum became known throughout Europe for its quality products. The company entered into negotiations and eventually landed supplier contracts with several European automakers, filling orders through export sales from its factory in the United States. Because of the combination of increased shipping costs and its European customers' desire to move toward just-in-time inventory systems, Magnum began thinking about investing in a production facility somewhere in Europe. The ownership and control of foreign assets, such as a manufacturing plant, is known as foreign direct investment. Exhibit 1.1 summarizes some of the major reasons for foreign direct investment.

Two ways for Magnum to establish a manufacturing presence in Europe were to purchase an existing mirror manufacturer (acquisition) or to construct a brand-new plant (greenfield investment). In either case, the company needed to calculate the net present value (NPV) from the potential investment to make sure that the return on investment would be adequate. Determination of NPV involves forecasting future profits and cash flows, discounting those cash flows back to their present value, and comparing this with the amount of the investment. NPV calculations inherently involve a great deal of uncertainty.

In the early 1990s, Magnum identified a company in Portugal (Espelho Ltda.) as a potential acquisition candidate. In determining NPV, Magnum needed to forecast future cash flows and determine a fair price to pay for Espelho. Magnum had to deal with several complications in making a foreign investment decision that would not have come into play in a domestic situation.

First, to assist in determining a fair price to offer for the company, Magnum asked for Espelho's financial statements for the past five years. The financial statements had been prepared in accordance with Portuguese accounting rules, which were much different from the accounting rules Magnum's managers were familiar with. The balance sheet did not provide a clear picture of the company's assets,

[3] A derivative is a financial instrument whose value is based on (or derived from) a traditional security (such as a stock or bond), an asset (such as foreign currency or a commodity like gold), or a market index (such as the S&P 500 index). In this example, the value of the British-pound option is based on the price of the British pound.

EXHIBIT 1.1
Reasons for Foreign Direct Investment

Source: Alan M. Rugman and Simon Collinson, *International Business*, 4th ed. (Essex, England: Pearson Education Limited, 2006), pp. 70–77.

Increase Sales and Profits

International sales may be a source of higher profit margins or of additional profits through additional sales. Unique products or technological advantages may provide a comparative advantage that a company wishes to exploit by expanding sales in foreign countries.

Enter Rapidly Growing or Emerging Markets

Some international markets are growing much faster than others. Foreign direct investment is a means for gaining a foothold in a rapidly growing or emerging market. The ultimate objective is to increase sales and profits.

Reduce Costs

A company sometimes can reduce the cost of providing goods and services to its customers through foreign direct investment. Significantly lower labor costs in some countries provide an opportunity to reduce the cost of production. If materials are in short supply or must be moved a long distance, it might be less expensive to locate production close to the source of supply rather than to import the materials. Transportation costs associated with making export sales to foreign customers can be reduced by locating production close to the customer.

Gain a Foothold in Economic Blocs

To be able to sell its products within a region without being burdened by import taxes or other restrictions, a company might establish a foothold in a country situated in a major economic bloc. The three major economic blocs are the North American Free Trade Association (NAFTA), the European Union, and an Asian bloc that includes countries such as China, India, Indonesia, Malaysia, the Philippines, South Korea, Taiwan, and Thailand.

Protect Domestic Markets

To weaken a potential international competitor and protect its domestic market, a company might enter the competitor's home market. The rationale is that a potential competitor is less likely to enter a foreign market if it is preoccupied with protecting its own domestic market.

Protect Foreign Markets

Additional investment in a foreign country is sometimes motivated by a need to protect that market from local competitors. Companies generating sales through exports to a particular country sometimes find it necessary to establish a stronger presence in that country over time to protect their market.

Acquire Technological and Managerial Know-How

In addition to conducting research and development at home, another way to acquire technological and managerial know-how is to set up an operation close to leading competitors. Through geographical proximity, companies find it easier to more closely monitor and learn from industry leaders and even hire experienced employees from the competition.

and many liabilities appeared to be kept off-balance-sheet. Footnote disclosure was limited, and cash flow information was not provided. This was the first time that Magnum's management became aware of the significant differences in accounting between countries. Magnum's accountants spent much time and effort restating Espelho's financial statements to a basis that Magnum felt it could use for valuing the company.

Second, in determining NPV, cash flows should be measured on an after-tax basis. To adequately incorporate tax effects into the analysis, Magnum's management had to learn a great deal about the Portuguese income tax system and the taxes and restrictions imposed on dividend payments made to foreign parent companies. These and other complications make the analysis of a foreign investment much more challenging than the analysis of a domestic investment.

Magnum determined that the purchase of Espelho Ltda. would satisfy its European production needs and also generate an adequate return on investment. Magnum acquired all of the company's outstanding common stock, and Espelho Ltda. continued as a Portuguese corporation. The investment in a subsidiary located in a foreign country created several new accounting challenges that Magnum previously had not been required to address.

Financial Reporting for Foreign Operations

As a publicly traded company in the United States, Magnum Corporation is required to prepare consolidated financial statements in which the assets, liabilities, and income of its subsidiaries (domestic and foreign) are combined with those of the parent company. The consolidated financial statements must be presented in U.S. dollars and prepared using U.S. GAAP. Espelho Ltda., being a Portuguese corporation, keeps its accounting records in euros (€) in accordance with Portuguese GAAP.[4] To consolidate the results of its Portuguese subsidiary, two procedures must be completed.

First, for all those accounting issues for which Portuguese accounting rules differ from U.S. GAAP, amounts calculated under Portuguese GAAP must be converted to a U.S. GAAP basis. To do this, Magnum needs someone who has expertise in both U.S. and Portuguese GAAP and can reconcile the differences between them. Magnum's financial reporting system was altered to accommodate this conversion process. Magnum relied heavily on its external auditing firm (one of the so-called Big Four firms) in developing procedures to restate Espelho's financial statements to U.S. GAAP.

Second, after the account balances have been converted to a U.S. GAAP basis, they then must be translated from the foreign currency (€) into US$. Several methods exist for translating foreign currency financial statements into the parent's reporting currency. All the methods involve the use of both the current exchange rate at the balance sheet date and historical exchange rates. By translating some financial statement items at the current exchange rate and other items at historical exchange rates, the resulting translated balance sheet no longer balances, as can be seen in the following example:

Assets	€ 1,000	×	$1.35	US$1,350
Liabilities	600	×	1.35	810
Stockholders' equity	400	×	1.00	400
	€ 1,000			US$1,210

To get the US$ financial statements back into balance, a translation adjustment of US$140 must be added to stockholders' equity. One of the major debates in translating foreign currency financial statements is whether the translation adjustment should be reported in consolidated net income as a gain or whether it should simply be added to equity with no effect on income. Each country has developed rules regarding the appropriate exchange rate to be used for the various financial statement items and the disposition of the translation adjustment. Magnum's accountants needed to learn and be able to apply the rules in force in the United States.

[4] Note that in 2005 Portugal adopted International Financial Reporting Standards for publicly traded companies, in compliance with European Union regulations. However, as a wholly owned subsidiary, Espelho Ltda. continues to use Portuguese GAAP in keeping its books.

International Income Taxation

The existence of a foreign subsidiary raises two kinds of questions with respect to taxation:

1. What are the income taxes that Espelho Ltda. has to pay in Portugal, and how can those taxes legally be minimized?
2. What are the taxes, if any, that Magnum Corporation has to pay in the United States related to the income earned by Espelho in Portugal, and how can those taxes legally be minimized?

All else being equal, Magnum wants to minimize the total amount of taxes it pays worldwide because doing so will maximize its after-tax cash flows. To achieve this objective, Magnum must have expertise in the tax systems in each of the countries in which it operates. Just as every country has its own unique set of financial accounting rules, each country also has a unique set of tax regulations.

As a Portuguese corporation doing business in Portugal, Espelho Ltda. will have to pay income tax to the Portuguese government on its Portuguese source income. Magnum's management began to understand the Portuguese tax system in the process of determining after-tax net present value when deciding to acquire Espelho. The United States taxes corporate profits on a worldwide basis, which means that Magnum will also have to pay tax to the U.S. government on the income earned by its Portuguese subsidiary. However, because Espelho is legally incorporated in Portugal (as a subsidiary), U.S. tax generally is not owed until Espelho's income is repatriated to the parent in the United States as a dividend. (If Espelho were registered with the Portuguese government as a branch, its income would be taxed currently in the United States regardless of when the income is remitted to Magnum.) Thus, income earned by the foreign operations of U.S. companies is subject to double taxation.

Most countries, including the United States, provide companies relief from double taxation through a credit for the amount of taxes already paid to the foreign government. Tax treaties between two countries might also provide some relief from double taxation. Magnum's tax accountants must be very conversant in U.S. tax law as it pertains to foreign source income to make sure that the company is not paying more taxes to the U.S. government than is necessary.

International Transfer Pricing

Some companies with foreign operations attempt to minimize the amount of worldwide taxes they pay through the use of discretionary transfer pricing. Auto mirrors consist of three major components: mirrored glass, a plastic housing, and a steel bracket. The injection-molding machinery for producing the plastic housing is expensive, and Espelho Ltda. does not own such equipment. The plastic parts that Espelho requires are produced by Magnum in the United States and then shipped to Espelho as an intercompany sale. Prices must be established for these intercompany transfers. The transfer price generates sales revenue for Magnum and is a component of cost of goods sold for Espelho. If the transfer were being made within the United States, Magnum's management would allow the buyer and the seller to negotiate a price that both would be willing to accept.

This intercompany sale is being made from one country to another. Because the income tax rate in Portugal is higher than that in the United States, Magnum requires these parts to be sold to Espelho at as high a price as possible. Transferring parts to Portugal at high prices shifts gross profit to the United States that otherwise would be earned in Portugal, thus reducing the total taxes paid to both countries. Most governments are aware that multinational companies have the ability to shift profits between countries through discretionary transfer pricing. To make sure that companies pay their fair share of local taxes, most countries have laws that regulate international transfer pricing. Magnum Corporation must be careful that, in transferring parts from the United States to Portugal, the transfer price is acceptable to tax authorities in both countries. The United States, especially, has become aggressive in enforcing its transfer pricing regulations.

Performance Evaluation of Foreign Operations

To ensure that operations in both the United States and Portugal are achieving their objectives, Magnum's top management requests that the managers of the various operating units submit periodic reports to headquarters detailing their unit's performance. Headquarters management is interested in evaluating the performance of the operating unit as well as the performance of the individuals responsible for managing those units. The process for evaluating performance that Magnum has used in the past for its U.S. operations is not directly transferable to evaluating the performance of Espelho Ltda. Several issues unique to foreign operations must be considered in designing the evaluation system. For example, Magnum has to decide whether to evaluate Espelho's performance on the basis of euros or U.S. dollars. Translation from one currency to another can affect return-on-investment ratios that are often used as performance measures. Magnum must also decide whether reported results should be adjusted to factor out those items over which Espelho's managers had no control, such as the inflated price paid for plastic parts imported from Magnum. There is no universally correct solution to the various issues that Magnum must address, and the company is likely to find it necessary to make periodic adjustments to its evaluation process for foreign operations.

International Auditing

The primary objective of Magnum's performance evaluation system is to maintain control over its decentralized operations. Another important component of the management control process is internal auditing. The internal auditor must (1) make sure that the company's policies and procedures are being followed and (2) uncover errors, inefficiencies, and, unfortunately, at times fraud. There are several issues that make the internal audit of a foreign operation more complicated than domestic audits.

Perhaps the most obvious obstacle to performing an effective internal audit is language. To be able to communicate with Espelho's managers and employees—asking the questions that need to be asked and understanding the answers—Magnum's internal auditors need to speak Portuguese. The auditors also need to be familiar with the local culture and customs, because these may affect the amount of work necessary in the audit. This familiarity can help to explain some of the behavior encountered and perhaps can be useful in planning the audit. Another important function of the internal auditor is to make sure that the company is in compliance with the Foreign Corrupt Practices Act, which prohibits a U.S. company from paying bribes to foreign government officials to obtain business. Magnum needs to make sure that internal controls are in place to provide reasonable assurance that illegal payments are not made.

External auditors encounter the same problems as internal auditors in dealing with the foreign operations of their clients. External auditors with multinational company clients must have expertise in the various sets of financial accounting

EXHIBIT 1.2
The History of KPMG

Source: KPMG Campus, www.kpmgcampus.com/kpmg-family/kpmg-history.shtml, accessed February 1, 2013.

KPMG was formed in 1987 through the merger of Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG). KPMG's history can be traced through the names of its principal founding members—whose initials form the name "K.P.M.G."

- **K** stands for Klynveld. Piet Klynveld founded the accounting firm Klynveld Kraayenhof & Co. in Amsterdam in 1917.
- **P** is for Peat. William Barclay Peat founded the accounting firm William Barclay Peat & Co. in London in 1870.
- **M** stands for Marwick. James Marwick founded the accounting firm Marwick, Mitchell & Co. with Roger Mitchell in New York City in 1897.
- **G** is for Goerdeler. Dr. Reinhard Goerdeler was for many years chairman of the German accounting firm Deutsche Treuhand-Gesellschaft.

In 1911, William Barclay Peat & Co. and Marwick Mitchell & Co. joined forces to form what would later be known as Peat Marwick International (PMI), a worldwide network of accounting and consulting firms.

In 1979, Klynveld joined forces with Deutsche Treuhand-Gesellschaft and the international professional services firm McLintock Main Lafrentz to form Klynveld Main Goerdeler (KMG).

In 1987, PMI and KMG and their member firms joined forces. Today, all member firms throughout the world carry the KPMG name exclusively or include it in their national firm names.

rules as well as the auditing standards in the various jurisdictions in which their clients operate. Magnum's external auditors, for example, must be capable of applying Portuguese auditing standards to attest that Espelho's financial statements present a true and fair view in accordance with Portuguese GAAP. In addition, they must apply U.S. auditing standards to verify that the reconciliation of Espelho's financial statements for consolidation purposes brings the financial statements into compliance with U.S. GAAP.

As firms have become more multinational, so have their external auditors. Today, the Big Four international accounting firms are among the most multinational organizations in the world. Indeed, one of the Big Four accounting firms, KPMG, is the result of a merger of four different accounting firms that originated in four different countries (see Exhibit 1.2) and currently has offices in more than 150 jurisdictions around the world.

Cross-Listing on Foreign Stock Exchanges

Magnum's investment in Portugal turned out to be extremely profitable, and over time the company established operations in other countries around the world. As each new country was added to the increasingly international company, Magnum had to address new problems associated with foreign GAAP conversion, foreign currency translation, international taxation and transfer pricing, and management control.

By the beginning of the 21st century, Magnum had become a truly global enterprise, with more than 10,000 employees spread across 16 different countries. Although the United States remained its major market, the company generated less than half of its revenues in its home country. Magnum eventually decided that in addition to its stock being listed on the New York Stock Exchange (NYSE), there would be advantages to having the stock listed and traded on several foreign stock exchanges. Most stock exchanges require companies to file an annual report and specify the accounting rules that must be followed in preparing financial