**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 foreign operations.

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, with a focus on the accounting issues encountered by multinational companies engaged in international trade and invested in foreign operations.

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 GAAP, tax laws, and other regulations differ across countries.

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 accounting harmonization. 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 more than doubled in the 1990s.

VII. The tremendous growth in foreign direct investment (FDI) over the last two 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 twice as large as the revenues generated through exporting.

VIII. There are more than 82,000 multinational companies in the world in 2009 with 810,000 foreign subsidiaries. The 100 largest multinationals generate approximately 4% of global GDP. A disproportionate number of multinational corporations are headquartered in the triad countries of the United States, Japan, and the European Union.

IX. The largest companies in the world are not necessarily the most multinational. Indeed, many large U.S. companies have no foreign operations. According to one definition of multinationality used by the United Nations, the two most multinational companies in the world in 2011 were based in Switzerland (Nestlé SA) and the United Kingdom (Anglo American plc).

X. In addition to establishing operations overseas, many companies also cross-list their shares on stock exchanges outside of their home country. There are a number of reasons for doing this including having access to a larger pool of capital.

## **Answers to Questions**

### 1. In 2011, companies worldwide exported over $18.3 trillion worth of merchandise. Although international trade has existed for thousands of years, recent growth in trade has been phenomenal. Over the period 1996-2011, U.S. exports increased from $625 billion to $1,480 billion per year, a 137% increase. During the same period, Chinese exports increased eight-fold to $1,898 billion in 2011.

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.

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 about 1.5 times as high as global exports in 2011, compared to almost parity about three decades earlier. Global sales of foreign affiliates comprises about one tenth 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. In addition, supplementary disclosures about foreign operations might be required.

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 so as to minimize the amount of taxes paid to the host country, 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, foreign assets, and the number of foreign employees might be provided in a company’s 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)

[Students familiar with U.S. GAAP will recognize this approach as being procedures required by FASB Statement No. 52 for foreign subsidiaries with a foreign currency as their functional currency.]

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

[Students familiar with U.S. GAAP will recognize this as being the approach required in accounting for foreign currency payables and receivables.]

2. Sony has intercompany transactions that result in one affiliate paying foreign currency to (or receiving foreign currency from) another affiliate. The company uses foreign exchange forward contracts and foreign currency option contracts to fix the local currency value of the foreign currency that will be paid to (or received from) the affiliate. Sony does this for transactions that have already occurred (receivables and payables), as well as for transactions that are expected to occur (forecasted). For example, assume that Sony Mexico purchases goods from the parent company in Japan on February 1 with payment of 50 million Japanese yen to be made on March 31. Sony Mexico could enter into a two-month forward contract on February 1 that fixes the number of Mexican pesos it will need to pay to acquire 50 million Japanese yen on March 31. Alternatively, Sony Mexico could purchase a foreign currency option on February 1 that expires on March 31 that would give the company the option to purchase yen on that date at a predetermined price.

In addition, Sony uses forward contracts to fix the amount of local currency it will need to expend to be able to repay foreign currency loans (debt). For example, assume Sony has a loan of 10 million Swiss francs that comes in six months, and the company is concerned that the Swiss franc might appreciate against the Japanese yen during that period. The company could buy 10 million Swiss francs six-months forward thereby fixing the Japanese yen price that will be paid when the debt matures.

3. 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 USD0.30/BRL and Expenses are translated at an exchange rate of USD0.347368/BRL.

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?
* Do the translation procedures that result in a USD pre-tax loss make economic sense?

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

**Note: The answers to a. and b. provided below were as of December 31, 2012. The instructor should update these answers to the current date.**

a. A total of 525 non-U.S. companies representing 46 different countries were listed on the NYSE, NYSE MKT exchanges.

b. On December 31, 2012, the foreign countries with the most companies listed on the NYSE were: Canada (157); China (82); Brazil (26); U.K. (29); and Bermuda (19).

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.

5. 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 2013, this could be found by searching for “List of All Companies” in the LSE website.

**Note: The answers below come from an Excel spreadsheet “All Companies on the London Stock Exchange – At 31 December 2012.” The instructor should update these answers to the current date.**

a. The Excel spreadsheet lists 583 non-U.K. companies. These companies represent 65 different countries.

b. Australia (31), Brazil (0), Canada (32), China (5), France (3), Germany (7), Mexico (0), and the United States (43). 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, 28 Australian companies might be the same percentage of total publicly traded companies in Australia as is 8 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.

6. Based on the geographical distribution of Revenues (Net Sales) and Non-current (Long-term) Assets, AstraZeneca has a multinationality index (MNI) of 0.86 and Abbott Labs has a multinationality index of 0.58.



**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 overall stock market.
* Stock market risk, which is the chance that stock prices overall will decline over short or even long periods.
* Country/regional risk, which is the chance that domestic 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 investments in a foreign country will decrease in value if the U.S. dollar rises in value against that country’s currency.
* Manager risk, which is the chance that the advisers will do a poor job of selecting the securities, sectors, or groups of companies in which the Fund invests.

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

3. The Plain Talk About International Investing box discusses the fact that because foreign companies are not subject to the same accounting, auditing, and financial reporting standards and practices as U.S. companies, there exists a risk that the information made available by foreign companies is not as reliable or as useful in making investment decisions as information provided by U.S. companies.

4. The fund’s assets are distributed by region as follows: Europe (55%), Pacific (17%), Emerging Markets (23%), North America (3.8%), and Middle East (1.3%). Other than North America, this allocation might be affected by the number of firms listed on stock exchanges in those regions; relative risks – country and currency – across regions; relative growth potentials across regions; and/or differences in the quality and quantity of information provided by companies for making investment decisions.

5. The fund is most heavily invested in the U.K. (20%), Japan (8.9%), China (8.1%). Switzerland (7.8%), and France (7.6%). 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 U.K., France, and Germany to be more similar.

The fund has a very small amount of investment in Canadian operations, 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: financials, consumer discretionary, and industrials. These industries might be the most profitable or have the highest growth potential. As a regulated industry, financials might be perceived as providing more reliable information for making investment decisions than other sectors.