Chapter 1–Introduction to International Accounting

Accounting as a field of study in the U.S. is quite specialized and can be organized into two branches: financial and managerial. Financial accounting provides financial information to groups outside the firm: stockholders, financial analysts, creditors, regulators, and the public. Managerial accounting offers financial and operating information to the firm’s management to help them with control, planning, and resource allocation. Specialty areas within financial accounting are auditing and tax.

International accounting, which includes both managerial and financial accounting, is

International accounting is a well-established specialty area within accounting and has two major dimensions:

Important Basic Concepts

What is international business? It is any commercial activity that extends beyond one national boundary. It is a flow of goods, services, and capital from one entity in one nation to another entity in another nation. The growth in world trade has been faster in the services sector than in the goods sector. Firms of many sizes are involved in international trade. Although the largest firms are often the most prominent, a significant level of economic activity takes place in the smaller firms. Between 40 and 50 percent of midsized firms export goods or services.

A major reason for the recent increased emphasis on international accounting has been the change in international trade during the last 50 years. Prior to the middle of the 20th century, the dominant theory of international trade was based on the classical economic theory of comparative advantage. This theory says each nation should offer goods and services that it can produce relatively efficiently and should export those goods. The nation should also import other goods. This theory assumed that the factors of production (land, labor and capital) were fixed nationally.

The factors of production, however, are mobile and when this was realized, international trade shifted its emphasis to international investment and financing. Today’s multinational corporations (MNCs) are not simply U.S. or EU-based firms with a
The outlook for the world economy contains both positive and negative factors. On the plus side are the sharply improving inflation rates in many developing nations and the reduction of energy costs (compared to the 1970s). On the negative side are the uncertain outlook for interest rates, concern about developing countries’ debt load, persistent unemployment in some nations, concern about the environment from the rapid development of some countries, terrorism, and integrating former communist countries into the world economy.

**The Multinational Corporation**

Much international trade is conducted by a special category of entity, the multinational corporation. An MNC can be defined in a number of ways: scale of non-US operations, worldwide distribution of assets, nationality of owners, suppliers of capital and employees, and sources of profit. A true MNC is a world citizen and thus has no allegiance to any one particular nation as its headquarters or base of operations. The different attitudes of management toward international operations can be organized into three categories:

Various benefits can be achieved through the MNC:
1. Significant arbitrage benefits can be obtained through:
   a. exploitation of financing bargains
   b. reduction of taxes on financial flows
   c. the mitigation or shifting of risks to agents with a comparative advantage in bearing them
   d. diversification of cash flows received through foreign operations
   e. the exploitation of various institutional imperfections
   f. the capturing and appropriation of information

2. Other benefits include capital availability, and a desirable cost of capital for a considerable range of its capital budget

   The MNC’s objective is to maximize shareholder wealth, subject to environmental, regulatory and ethical constraints. The objective is sometimes difficult to achieve if managers decide to maximize their own utility functions. This is the agency problem, where the goals of shareholders conflict with those of the managers. The problem may be more frequent in the case of MNCs, where managers of different subsidiaries are more inclined to maximize the value of their respective subsidiaries. This problem calls for specific accounting standards to deal with the unique pressures of accountability from domestic and foreign interest groups.

   Firms typically evolve into MNCs, and this process is shown below:

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**Foreign Direct Investment**

Foreign direct investment involves the transfer of capital, managerial, and technical assets of a firm from one country to another by the same firm. Firms engage in direct foreign investment and expand their markets by producing and selling broad. Some of the reasons include the following:
· to reduce transportation costs
· lack of a domestic policy
· to achieve economies of scale in small-scale process technology
· to avoid trade or customer-supplied restrictions
· to follow customers and competitors
· to benefit from a different cost structure
· to achieve some vertical integration
· to rationalize production by taking advantage of varying costs of labor, capital, and raw materials
· to have access to production factors
· to take advantage of government investment incentives
· because of political motives
· to use a monopoly advantage over similar firms in foreign countries
· to have better profitability and stable sales and earnings.

Various models and theories can be used to explain foreign direct investment. They include the international trade theory, the location theory, the investment theory, the theory of the firm, and the industrial organization theory. Below is a summary of these theories:
The International Monetary System

The international monetary system constitutes the structure within which exchange rates are determined, international trade and capital flows are accumulated, and balance-of-payments adjustments are made. The UN Monetary and Financial Conference held in Bretton Woods, N.H. in 1944, with the objective of developing an international monetary structure, created both the International Monetary Fund (IMF) and the World Bank. At that time, the fixed exchange rate system or par value based on gold and the US dollar proved inadequate and called for reform. Crisis in the international monetary system caused by an overvalued dollar and growing US balance of trade deficits, caused in December 1971 the convening of another conference that resulted in the Smithsonian Agreement and the devaluation of the US dollar. A further devaluation of the dollar in 1973 showed the limits of the fixed rate system. From these crises there emerged the following exchange rate systems:

1. fixed rate system–where the value of the currency is “pegged” to another currency, allowed to fluctuate only within very narrow boundaries

2. freely floating exchange rate system–where the value of the currency is determined by market forces and not through intervention by government

3. managed-float exchange rate system–where the value of the currency is allowed to fluctuate and governments intervene to insure the value does not move too much in a given direction. It is also known as a "managed float" or “dirty float"

4. pegged exchange rate system–used by members of the EU to peg the value of their currencies to a basket of currencies, expressed in ECUs prior to the emergence of the EU single currency. The Euro was created by the various member nations’ currencies being irrevocably fixed with one another.

Global Capital Markets

Perhaps the most important factor that has increased the importance of international accounting is the emergence of a global capital market. The explosive growth in this market has been caused by the elimination of national capital controls, deregulation, improved communications, and disintermediation. Equity market capitalization as a percentage of gross domestic product during the late 1990s increased for many nations, primarily the developed nations. The number of domestic firms with shares listed in the late 1990s increased in some markets and decreased in others. Hundreds of foreign issuers have had their equity listed on the European, North American and Japanese stock exchanges for years. The number of foreign firms listed in most markets other than the NYSE and Nasdaq have been declining. Increasing numbers of foreign issuers are listing on Europe’s exchanges.

Various benefits and costs are associated with listing on a foreign stock
exchange. The benefits of listing on a foreign stock exchange include:

Given that the benefits outweigh the costs, a pressure exists for regulatory agencies such as the SEC to both protect investors with full disclosure requirements and yet attract foreign investment by increasing the competitiveness of their local stock exchanges through less costly disclosure requirements.
Accounting Standards for the MNC

MNCs are faced with a diversity of accounting standards to comply with. First, MNCs need to comply with the local standards of their country of origin, which will differ in some respect from the standards required in other countries. As a result, they need to be sensitive to the requirements of comparative international accounting. Second, MNCs need to comply with the international accounting standards set by the IASB, the international accounting standard setting body. As a result, they need to be sensitive to the requirements of standardized international accounting. Third, MNCs need to comply with the accounting techniques that can facilitate the conduct of their operations and insure their success.

There are now identifiable international constituencies which demand specific information from MNCs. In fact, the existence of an international investor group from different countries has created various unique reporting audiences-of-interest. The following reasons have been offered for such uniqueness:

- people living and working in different cultures have different characteristics, attitudes, life styles and general behavior patterns. These differences make for differing standards of comparison and possibly lead to different decision processes.

- investment institutions differ from country to country, thus causing differing information wants and usage.

- accounting principles, as financial statement users understand them, differ from country to country.

The second question—what should be required by the standards—is somewhat difficult to answer given the lack of knowledge of the decision requirements of user groups. Examples of various issues involve:
The Need for International Accounting

These various factors of the growth of MNCs, globalization, international monetary system, and foreign direct investment have created an environment in which business transactions, their conduct, measurement, and disclosure have more of a universal flavor. The probability that various parties to a business transaction are based in different countries has increased. From a decision-making perspective, these parties need to obtain relevant information on those they conduct business with and increasingly this information exists in an accounting language different than their own. In order to make an informed decisions in a global environment, one needs to have an understanding of international accounting issues.

Thus, we can say that there is now a new type of information seeker—the international information seeker. This person’s interests go beyond conventional information to include concerns about political risks, foreign exchange effects, and international performance. Annual reports of MNCs are now more internationally oriented, including translation of annual reports in one or more languages, separate disclosure of the extent of international involvement, employee reporting, valued added reporting, social responsibility reporting, and other innovations. To meet the requirements of a multiple audience of interests from different countries, three identifiable approaches have been advocated:
The Internationalization of the Accounting Profession

One important result of the rise of international accounting is the internationalization of the accounting profession. It can be seen in the development of international and regional accounting bodies making their entrance in the standards-setting arena and in the growing network of international firm partnerships or liaisons. In effect, various organizations have in recent years made some efforts to harmonize accounting standards. These organizations include the Accounting International Study Group, the International Accounting Standards Board, the EU, the UN, the International Federation of Accountants, and the Union of European Accountants.

The internationalization of the accounting profession can be seen in the growing network of international firm partnerships and liaisons. International accounting firms have developed for the most part to meet the needs of affiliates or subsidiaries of MNCs. The following reasons have been proposed for this phenomenon:

1. Common bases of reporting–

2. Common auditing standards–
3. Reliance on the work of other auditors–

4. International financing requirements–international investment banking firms that underwrite securities and international financial institutions require audited statements from accounting firms whose auditing and reporting standards and professional training and judgment are reliable.

International accounting firms have several problems here, however. One serious problem is the result of nationalism and the call for local control of all foreign operations. In certain countries, non-nationals are refused international recognition of their qualifications as well as their right to practice.

A second problem of the accounting firms is to maintain good standards of fieldwork and quality-control procedures through careful international coordination. A third problem arises from the need to find high-caliber local staff in each country.

**Accounting and Economic Development**

Accounting has a dual function in the economic development process, with a role at the micro level and a role at the macro level. At the micro level, accounting will be helpful to corporations and micro-governmental units in measuring, reporting, and disclosing information about their financial position and performance. At the macro level, accounting will be helpful to governments and nations in measuring, reporting, and disclosing national economic performance. The following contributions can be made by accounting to development planning:

1. Definition, classification, and valuation of transactions and stocks for all social accounts, in particular the national income and input-output accounts

2. Assessment of, and changes in, the components of input output data capital coefficients and shadow prices, the latter being the true factors of production

3. A uniform and standardized system of industrial accounts
4. Up-to-date cost accounting procedures for cost-benefit calculations

5. Assistance in devising economic policies, measures and programs

6. Control and audit the plan and reporting the results.

Economic development rests on a successful industrialization and the efficient mobilization of capital. Accounting helps to evaluate the success of both endeavors.