International Accounting

Fifth Edition

Holt • Hein

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PREFACE

The fifth edition of International Accounting is a substantial update and revision of the fourth edition. International accounting changes rapidly, and we have therefore developed a website for use by students and professors:

www.intcomm.net/~pholt/i5.htm

This website contains numerous links and other resources with vast, updated information about many international accounting topics. It is the belief of the authors that an international accounting textbook should inform, teach, and inspire, but it is only a beginning. Students should be encouraged to supplement their study with the internet and other valuable resources.

The chapters of the book have been rearranged; some have been added, some deleted. New topics have been integrated into the text, and obsolete material has been removed. Unfortunately, my good friend and co-author, Dr. Cheryl Hein, died before we completed work on the fifth edition. Her students and our family miss her very much. But she did leave behind many notes, not to mention her wisdom. She has left her influence in every chapter of this book.

Chapter one is an introduction to international accounting. It presents the environments that affect the development of accounting in different countries and includes a discussion of ethics in international business.

Chapter two introduces the critical issues related to standardization and harmonization and provides an overview of basic accounting concepts that the student must understand before proceeding. At this point, the student's view of accounting should become world embracing. The student must look at concepts with a new attitude, not just for the purpose of memorizing the accounting rules of one country, but for understanding the potential for different interpretations and applications in other countries.

Chapter three provides an overview of organizations that are concerned with the problem of international diversity in accounting methods. At the conclusion of this chapter, the student will have a good beginning knowledge of the international harmonization problem.

Chapters four, five, and six divide countries into four groups, US-UK, Continental, South American, and others, and describes accounting in a few representative countries. Chapter seven gives an overview of international accounting standards as promulgated by the International Accounting Standards Committee and describes a few of the differences between international accounting standards and US GAAP.

Chapters eight and nine are more technical. Chapter eight covers the accounting for foreign currency transactions, including journal entries. Chapter nine presents foreign currency translation, with examples.

Chapter ten describes differences in reporting requirements among countries and provides examples of difficulties in financial statement analysis. Major topics include disclosure, aggregation vs dis-aggregation, segmentation, consolidation, reporting for foreign financial markets, social responsibility, and inflation reporting.

Chapter eleven describes some of the types of taxes a multinational company may encounter, and specifics of taxation in several countries are presented.

Chapter twelve discusses international managerial accounting. There are a vast number of topics that could be included under this heading, but this chapter focuses on transfer pricing, management of exchange risk, evaluation of performance of foreign subsidiaries, rate of return on foreign operations, and centralization vs decentralization.

Chapter thirteen describes some of the differences in auditing worldwide.

Chapter fourteen, about the Bretton Woods system and the development of various trading areas, was one of the chapters originally written by Cheryl Hein. Except for a few changes for updates, it remains very much as she originally wrote it.

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CHAPTER 1

INTRODUCTION TO INTERNATIONAL ACCOUNTING

INTRODUCTION

You might think that international accounting is a relatively new subject. Indeed, many universities have added international accounting to their curricula only in recent years. But the subject is thousands of years old, as old as international trade. When you think of it, ancient wars required accounting. If you won, you'd have to know how many captives you took, and the amount and value of plunder. If your war was with another country, you were using a form of international accounting. Record keeping began very early in civilization; an Egyptian record from before 3400 BCE notes numbers of prisoners, oxen and goats, and depreciation was used in early Roman and Greek business.

Cleopatra is known to have understood and used the concept of a tariff. When certain goods were imported to Egypt, she required a substantial payment, a practice which significantly increased the wealth of her country. She was an able administrator who engaged the services of fine accountants who understood international trade.

There are accounting records from the Roman Empire that look like double entry accounting, but double entry accounting really began in the 15th century in Italy. In 1494, Luca Pacioli, an Italian monk, issued a document which described the principles of double entry bookkeeping which became the basis of present-day accounting. Double entry accounting may very well have been one of the most significant discoveries in history, because modern international trade would have been very difficult without it.

As international trade expanded, developments in accounting took place in principal trading countries at different rates. The Industrial Revolution, which began in the United Kingdom (UK), rapidly spread across Europe and the US and led to greatly increased international trade. The tremendous growth of industry in the 19th and 20th centuries was accompanied by more sophisticated accounting methods as production methods became more complex and varied. Accounting had to adapt at the same time to increasing government regulation and taxation of business. In the 20th century particularly, finance became exceedingly complicated as international acquisitions became commonplace and multinational corporations (MNCs) grew dramatically, placing new demands on accounting to inform governments, creditors, owners, and managers.

Multinational companies, which are companies that do business in more than one country, have increased in number, and they face increasing complications in presenting reports to their shareholders and governments. Each country in which the company does business insists on its own accounting procedures, especially for taxation purposes. But the parent company has to recognize the financial status of its subsidiary enterprises in foreign countries in issuing its own consolidated financial statements; and the parent company has to present those consolidated financial statements in accordance with the accounting rules in its own country of domicile. Before the consolidated financial statements can be prepared, the financial statements of each of the foreign subsidiaries has to be recast into the accounting principles and the currency of the parent company's country.

Business is becoming increasingly internationalized and more and more complex. Without an understanding of accounting systems in other countries it becomes difficult, if not impossible, for an MNC to conduct its operations profitably and to comply with all government regulations.

Accounting rules are different in different countries, but not by accident or chance. A number of factors influence how the accounting requirements develop in a given country. In the remainder of this chapter, the following factors are discussed: the economic environment, the legal environment, the political environment, capital markets, cultural environment, educational environment, the ethical environment, and social and other environments. This is not an exhaustive list, nor is it realistic to think we could possibly list all the factors that affect the development of accounting in a particular country. Further, these factors are interrelated to the extent that it is not possible to discuss one of these factors without reference to others.

Because of its importance, the ethical environment factor is discussed more extensively than any of the others, and it can be argued that the ethical environment in a given country is affected by all the other factors.

ECONOMIC ENVIRONMENT

A country's economy consists of numerous factors, all of which affect the lives of its citizens. Some of the economic factors that affect how accounting is done in a given country are the level of economic development, stability, foreign exchange, inflation, and unemployment.

LEVEL OF DEVELOPMENT

Countries that are not highly developed economically have little need for sophisticated accounting systems and would prefer not to go through the difficult, costly and time-consuming process of creating their own national standards. A primarily rural economy such as that of Haiti is more focused on feeding the population than on making international investments. As countries become more industrialized, their need for accounting information increases.

Accounting in the US was not especially complicated when the US was primarily rural and had an economy that was based mostly on agriculture. Later, as railroads, steamships and manufacturing became more important to the economy, businesses required a lot more investment capital. Lenders and equity investors could provide that capital, but needed more thorough and sophisticated accounting information on which to base their investing decisions. As other countries became more industrialized, they too needed to develop better accounting systems. This greater public demand for financial information resulted in a demand for accounting rules and regulations to provide consistent and reliable information about companies and their finances.

STABILITY

Some economies are more stable than others. Those countries that are not very stable will encounter greater demands by investors. If you thought a government was likely to be overthrown in a political coup in the near future, you would be less likely to invest in that risky country unless your potential return was quick and significantly higher than investing in a more stable country.

For example, Peru has had much political uncertainty over a period of decades. Various regimes have imposed price and exchange rate controls, expropriated private assets, restricted or prohibited the payment of dividends outside the country, and restricted imports. At times, when unemployment was a problem, the government simply restricted companies' rights to terminate employees. Terrorists have at times been very active in Peru. Under these conditions, investors were less likely to invest in Peru than in more stable environments. During the 1990s, the political and economic environment in Peru did improve, making Peru somewhat more attractive to investors.

If a country's politics and economy are stable, an MNC is more likely to make substantial investments in that country. The MNC would be willing to build factories, train employees, develop a working relationship with the government, and to set many goals which take considerable time to achieve.

Accounting in an unstable environment is likely to be rather basic and might change drastically with new ruling regimes. With more stability and the long-term commitments that stability allows, accounting has to be sophisticated enough to reflect the effects of complicated transactions over a number of accounting periods and to disclose the important elements of the more complicated financial instruments that will arise.

FOREIGN EXCHANGE

Some countries have well-developed capital markets and exchange rates which are quoted daily in the Wall Street Journal and other sources. These countries' economies are stable enough that other countries can count on freely exchanging currency at quoted rates. In many instances, however, countries do not have a currency which is stable or readily convertible into other currencies.

Even in those countries whose currencies are easily converted into US dollars (and vice versa), the exchange rates may change on a daily basis. If the dollar is worth 3.03 Mexican new pesos today, it may be worth 6.00 new pesos or more in the future. Such a change is known as weakening of the peso against the dollar, because it takes fewer dollars to acquire the same number of pesos. Correspondingly, in terms of US currency, the dollar has strengthened against the peso.

These variations in the value of currencies from day to day can have a profound effect on a company doing business in different countries. Say, for example, that you purchased 10,000 sombreros at ten pesos each, on credit, from a company in Mexico and payable later in pesos. At the time you purchased the hats, the value of the Mexican peso was 4.00 to the dollar. Unfortunately for you, at the time you need to pay for the sombreros, the value of the peso has strengthened to, say 3.20 to the dollar. Stated from the Mexican peso perspective, the peso was worth .25 dollars (1/4.00), but strengthened to .3125 dollars (1/3.20). Therefore, instead of owing $25,000 (10,000 sombreros times 10 pesos per sombrero times $.25 per peso), you would owe $31,250 (10,000 sombreros times 10 pesos per sombrero times $.3125 per peso).

On the other hand, you may be able to postpone payment for a while and, if you're lucky, the