

INTERNATIONAL ACCOUNTING

SEVENTH EDITION



FREDERICK D. S. CHOI

GARY K. MEEK

Seventh Edition

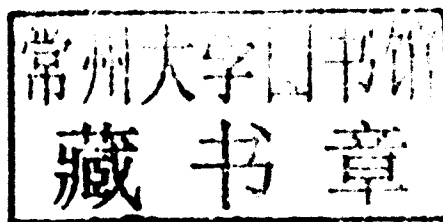
INTERNATIONAL ACCOUNTING

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Library of Congress Cataloging-in-Publication Data

Choi, Frederick D. S.,
International accounting / Frederick D.S. Choi, Gary K. Meek.—7th ed.
p. cm.
Includes index.
ISBN-13: 978-0-13-611147-4 (alk. paper)
ISBN-10: 0-13-611147-5 (alk. paper)
1. International business enterprises—Accounting. I. Meek, Gary K., II. Title.
HF5686.I56C53 2011
657'.96—dc22

2010014971

10 9 8 7 6 5 4 3 2 1

Prentice Hall
is an imprint of



www.pearsonhighered.com

ISBN 10: 0-13-611147-5
ISBN 13: 978-0-13-611147-4

To our families

PREFACE

This book is written with the express purpose of introducing students to the international dimensions of accounting, financial reporting and financial control. The world in which they will pursue their professional careers is a world dominated by global business and cross-border investing. As these activities require decisions premised on financial data, a knowledge of international accounting is crucial for achieving proper understanding in external and internal financial communications. While ideal for upper division undergraduate students and masters students, we are pleased that the contents of this award-winning effort have also benefited practicing accountants, financial executives, investment managers, university educators and professional administrators around the world.

This revision of a work that has spanned four decades features a number of enhancements. These include:

- Updated coverage of corporate governance and related legislation. See Chapters 4, 5, 8 and 9.
- Examination of international auditing, both external and internal. See Chapters 8 and 9.
- Current discussion of comparative accounting emphasizing developments in Europe, the Americas and Asia in Chapters 3 and 4.
- Capital market, managerial, taxation and institutional updates reflective of current trends and issues throughout most chapters.
- Discussion of international accounting convergence and the major players in this important effort. See Chapters 3, 5 and 8.
- Examination of reporting and disclosure practices spanning both developed and emerging market countries. See Chapters 4, 5 and 7.
- Expanded listings of relevant international Web site addresses and data sources.
- Updated discussion questions, exercises and cases.

We have benefited from the professional literature and from many of our students and faculty colleagues whose thoughtful comments have triggered new ideas for us to consider. We are in their debt. In addition, many individuals furnished able assistance in producing the manuscript. We especially thank Julie Broich, Karen Kirincich and Christina Rumbaugh at Prentice Hall for their encouragement and editorial support.

However hard one tries to avoid them, errors are bound to occur in a work of this type. As authors, we accept full responsibility for all errors and omissions in the manuscript. As always we welcome constructive comments from all who use this book as students are the ultimate beneficiaries of your thoughtfulness.

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New York, N.Y.

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Stillwater, OK

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Introduction

Accounting plays a vital role in society. As a branch of economics, it provides information about a firm and its transactions to facilitate resource allocation decisions by users of that information. If the information reported is reliable and useful, scarce resources are allocated in an optimal fashion, and conversely, resource allocations are less than optimal when information is less reliable and useful.

International accounting, the subject of this text, is no different in its intended role. What makes its study distinctive is that the entity being reported on is either a multinational company (MNC) with operations and transactions that cross national boundaries, or an entity with reporting obligations to users who are located in a country other than that of the reporting entity.

Recall that accounting entails several broad processes: measurement, disclosure, and auditing. Measurement is the process of identifying, categorizing, and quantifying economic activities or transactions. These measurements provide insights into the profitability of a firm's operations and the strength of its financial position. Disclosure is the process by which accounting measurements are communicated to their intended users. This area focuses on issues such as what is to be reported, when, by what means, and to whom. Auditing is the process by which specialized accounting professionals (auditors) attest to the reliability of the measurement and communication process. Whereas internal auditors are company employees who answer to management, external auditors are nonemployees who are responsible for attesting that the company's financial statements are prepared in accordance with generally accepted standards.

An understanding of the international dimensions of the accounting processes that were just described is important to those engaged in importing or exporting activities, as well as those seeking to manage a business, or obtain or supply financing across national borders. Even a company operating solely within the confines of a single country is no longer insulated from the international aspects of accounting as reliance on international vendors to contain production costs and remain globally competitive is a common feature of contemporary business. Accounting amounts may vary significantly according to the principles that govern them. Differences in culture, business practices, political and regulatory structures, legal systems, currency values, local inflation rates, business risks,

and tax codes all affect how the MNC conducts its operations and financial reporting around the world. Financial statements and other disclosures are impossible to understand without an awareness of the underlying accounting principles and business culture.

The importance of studying international accounting has grown over the years. We begin with a brief history of this subject.

HISTORICAL PERSPECTIVE

The history of accounting is an international history. The following chronology demonstrates that accounting has been remarkably successful in its ability to be transplanted from one national setting to another while allowing for continued development in theory and practice worldwide.

To begin, double-entry bookkeeping, generally thought of as the genesis of accounting as we know it today, emanated from the Italian city states of the 14th and 15th centuries. Its development was spurred by the growth of international commerce in northern Italy during the late Middle Ages and the desire of government to find ways to tax commercial transactions. “Bookkeeping in the Italian fashion” then migrated to Germany to assist the merchants of the Fugger era and the Hanseatic league. At about the same time, business philosophers in the Netherlands sharpened ways of calculating periodic income, and government officials in France found it advantageous to apply the whole system to governmental planning and accountability.

In due course, double-entry accounting ideas reached the British Isles. The development of the British Empire created unprecedented needs for British commercial interests to manage and control enterprises in the colonies, and for the records of their colonial enterprises to be reviewed and verified. These needs led to the emergence of accounting societies in the 1850s and an organized public accounting profession in Scotland and England during the 1870s. British accounting practices spread not only throughout North America but also throughout the British Commonwealth as it then existed.

Parallel developments occurred elsewhere. The Dutch accounting model was exported to Indonesia, among other places. The French accounting system found a home in Polynesia and French-administered territories in Africa while the reporting framework of the Germans proved influential in Japan, Sweden, and czarist Russia.

As the economic might of the United States grew during the first half of the 20th century, its sophistication in matters of accounting grew in tandem. Business schools assisted in this development by conceptualizing the subject matter and eventually having it recognized as an academic discipline in its own right on college and university campuses. After World War II, U.S. accounting influence made itself felt throughout the Western world, particularly in Germany and Japan. To a lesser extent, similar factors are directly observable in countries like Brazil, Israel, Mexico, the Philippines, Sweden, and Taiwan.

Despite this international heritage, in most countries accounting remained a nationalistic affair, with national standards and practices deeply anchored into national laws and professional regulations. (Examples of comparative accounting practices are provided in Chapters 3 and 4.) There was little understanding of parallel requirements in other countries. Yet, accounting increasingly served people and organizations whose decisions were increasingly international in scope.

Resolving the historical paradox of accounting has long been a concern of both users and preparers of accounting information. In recent years, institutional efforts to narrow differences in measurement, disclosure, and auditing processes around the world have intensified. A description of this effort and the major players with an important stake in attaining convergence of global accounting systems is the focus of Chapter 8.

CONTEMPORARY PERSPECTIVE

While the effort to reduce international accounting diversity is important in its own right, there are today a number of additional factors that are contributing to the growing importance of studying international accounting. These factors stem from significant and continuing reductions in national trade barriers and capital controls together with advances in information technology.

National controls on capital flows, foreign exchange, foreign direct investment, and related transactions have been dramatically liberalized in recent years, reducing the barriers to international business. Changes in financial sector policy in both developed and developing countries reflect the growing realization that information and financial technology render capital controls ineffective. National governments also realize that financial market liberalization affords them access to international funds with which to finance national debts. As accounting is the language of business, cross-border economic interactions mean that accounting reports prepared in one country must increasingly be used and understood by users in another.

Advances in information technology are also causing a radical change in the economics of production and distribution. Vertically integrated production is no longer proving an efficient mode of operation. Real-time global information linkages mean that production, including accounting services, is increasingly being outsourced, or *offshored*, to whomever in the world can do the job, or portions of the job, best.¹ Leading locations for offshore services today include Argentina, Brazil, Canada, Chile, Costa Rica, Mexico, and Panama in the Americas; Australia, China, India, Malaysia, New Zealand, Pakistan, the Philippines, Singapore, Thailand, and Vietnam in Asia Pacific; and the Czech Republic, Egypt, Hungary, Ireland, Israel, Morocco, Poland, Romania, Russia, Slovakia, South Africa, Spain and the Ukraine in Europe, the Middle East, and Africa.² Adversarial, arm's-length relationships that have characterized companies' relations with their suppliers, middle persons, and customers are being replaced by cooperative global linkages with suppliers, suppliers' suppliers, middle persons, customers, and customers' customers.

Exhibit 1-1 provides an illustration of the outsourcing phenomenon. In producing the ProLiant ML150, a small box that helps companies manage customer databases and run e-mail systems, among other things, Hewlett-Packard (H-P) turned to the usual sources of low-cost labor: China and India. However, it also decided to make some ML150s in higher-cost locations such as Singapore and Australia, which were closer to targeted customers. Initial design for the ML150 was done in Singapore and then handed off to an outside contractor in Taiwan. Although China possesses the lowest wage rates, it is but one part of a highly specialized manufacturing system.

¹ For example, see Arie Lewin, Silvia Massini, and Carine Peters, "Why Are Companies Offshoring Innovation? The Emerging Global Race for Talent," *Journal of International Business Studies* 40 (2009): 901–925.

² Robert Kennedy, "The Tough Game You Have to Play," *Financial Executive*, May 2009, pp. 23–25.