INTERNATIONAL ACCOUNTING

fifth edition

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International Accounting

Fifth Edition

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University of South Carolina

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Mc Graw Hill Education

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

—TSD

To Kaori, Alisa, Monica, and George

—MF

To my parents, and to Martina, Maurizio, Nicola, and Sara^2

—GG

To my wife, Sujatha, and daughter, Hasanka

—HBP

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Timothy S. Doupnik is a Distinguished Professor Emeritus of Accounting at the University of South Carolina, where he joined the faculty in 1982. 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 PhD from the University of Illinois.

Professor Doupnik has published exclusively in the area of international accounting in various academic journals, including *The Accounting Review; Accounting, Organizations, and Society; Abacus; Journal of International Accounting Research; Journal of Accounting Literature; International Journal of Accounting;* and *Journal of International Business Studies.*

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 international accounting at universities in a number of countries around the world, including Austria, Brazil, China, Dominican Republic, Finland, Germany, and Mexico.

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Mark Finn is a Clinical Professor of Accounting at the Kellogg School of Management, Northwestern University, having served on the Kellogg faculty since 1996. Prior to Kellogg, Professor Finn was on the faculty of the University of Chicago's Booth School of Business. He has also been affiliated with the Sasin Graduate Institute of Business Administration, Chulalongkorn University (Bangkok, Thailand), since 2003. He has been a visiting professor at the Indian School of Business (Hyderabad and Mohali) and Keio University (Hiyoshi, Japan). From 2001 to 2008 he was director of Kellogg's Global Initiatives in Management (GIM) program. He received a PhD from Cornell University and a BA with honors from Stanford University.

Professor Finn teaches core financial accounting and advanced classes in financial reporting, taxation, international accounting, and sustainability reporting. He received the Chairs' Core Teaching Award in 1999, 2005, 2008, 2012, and 2014 and the Indian School of Business's Teacher of the Year award in 2003, 2008, and 2009. Within the GIM program, he served as a faculty adviser to classes on China, Japan, India, and South Africa. His primary research interests are related to the quality and credibility of financial disclosures, especially in non-U.S. settings. His research articles include "Market Rewards for Increasing Earnings Patterns," published in the *Journal of Accounting Research.*

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Research; Management International Review; Journal of Business Ethics; Research in Accounting Regulation; and *Journal of Management and Governance.* He has taught international accounting to graduate students at various universities in Italy, Brazil, and the United States.

Professor Gotti is past president of the International Accounting Section of the American Accounting Association. He is a member of the Editorial Board of the *International Journal of Accounting* and Associate Editor of the *Journal of International Accounting, Auditing & Taxation.* He has been a member of the Scientific Committee of the European Accounting Association Annual Congress since 2016. He served as Associate Editor of the *Journal of International Accounting Research* in 2014–2017.

Hector B. Perera *Emeritus Professor*

Hector Perera is an Emeritus Professor at Massey University, New Zealand, where he taught and conducted research for 20 years. He joined Macquarie University in Australia in 2007, and retired in 2012. He has an undergraduate degree from the University of Ceylon (Peradeniya), Sri Lanka and a PhD from the University of Sydney, Australia.

Professor Perera's research has dealt mainly with international accounting issues and has been published in a number of scholarly journals, including *Journal of International Accounting Research; Critical Perspectives on Accounting; Journal of Accounting Literature; International Journal of Accounting; Advances in International Accounting; Journal of International Financial Management and Accounting; Abacus; Accounting and Business Research; Accounting Historians Journal; Accounting, Auditing and Accountability Journal; Journal of Contemporary Asia; British Accounting Review; Accounting Education—An International Journal; Australian Accounting Review; International Journal of Management Education; Emerald Emerging Markets Case Studies;* and *Pacific Accounting Review.* In an article appearing in a 1999 issue of the *International Journal of Accounting,* he was ranked fourth equal in authorship of international accounting research in U.S. journals over the period 1980–1996.

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 was on the editorial boards of *Accounting Horizons, Qualitative Research in Accounting and Management,* and *Pacific Accounting Review.*

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. It 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 IFRS; and coverage of nontraditional but important topics such as management accounting issues in 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 financial reporting issues especially relevant for multinational corporations.
- Incorporation of research findings into the discussion of 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 convergence of financial reporting standards.
- Two chapters on IFRS 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 foreign currency translation is 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 U.S. tax law. The chapter on international taxation covers the international tax provisions in the new U.S. tax law (Tax Cuts and Jobs Act of 2017).
- A chapter devoted to a discussion of the management accounting issues facing multinational corporations, with a focus on issues important for strategy formulation and implementation.

- Coverage of the importance of corporate governance in an international context and the role of auditing (external and internal) in enhancing it.
- A chapter on sustainability reporting, which is becoming increasingly more common among global enterprises and is now a mandatory part of the corporate reporting model in many countries.

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 efforts at converging accounting standards internationally.

- 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 several major models of accounting used internationally, 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 IASB. We explain the meaning of convergence, identify the arguments for and against convergence, and discuss the use of the IASB's IFRS internationally.

The universal recognition of IFRS as a set of global accounting standards is one of the most important trends in modern accounting. IFRS are used as the primary set of reporting standards in a majority of the world's economies. In countries that continue to use national standards, including the U.S. and India, IFRS provide a set of benchmarks toward which the national standards converge over time. 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; investment properties; biological assets; and intangible assets. The chapter also provides a discussion of accounting for business combinations and the scope of consolidation. Numerical examples demonstrate the application of IFRS, differences between IFRS and U.S. GAAP, and the implications for financial statements.
- Chapter 5 focuses on current liabilities, provisions, employee benefits, share-based payment, income taxes, revenue recognition, financial instruments, and leases, including major differences between IFRS and U.S. GAAP. This chapter also describes the requirements of IFRS in a variety of disclosure and presentation standards.

Chapters 6 and 7 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 6 and 7).

- Chapter 6 begins with a description of the foreign exchange market and then illustrates 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 present examples of 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 7 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. The appendix to this chapter covers the translation of foreign currency financial statements in hyperinflationary environments.

In terms of importance, business executives rank international taxation second only to foreign currency 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 8 and 9.

- Chapter 8 begins with a discussion of the types of taxes and different tax rates imposed on corporations by countries around the world. We describe different approaches countries take with respect to tax jurisdiction, the problem of double taxation due to overlapping tax jurisdictions, and mechanisms through which countries provide relief from double taxation, focusing on foreign tax credits. We summarize the U.S. approach to taxing income earned by foreign operations of U.S. corporations and provide an example to demonstrate application of this approach. We also discuss benefits of tax treaties and the translation of foreign currency amounts for tax purposes. The appendix to this chapter describes several issues related to U.S. taxation of expatriate individuals.
- Chapter 9 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.

[1] T. Conover, S. Salter, and J. Price, "International Accounting Education: A Comparison of Course Syllabi and CFO Preferences," *Issues in Accounting Education* 9, no. 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* 23, no. 1 (Fall 1987), pp. 64–82.

[2] Ibid.

Chapter 10 covers management accounting issues of particular relevance to multinational corporations. This chapter covers multinational capital budgeting as a vital component of strategy formulation and operational budgeting as a key ingredient in strategy implementation, and it discusses issues that must be addressed in designing a process for evaluating the performance of foreign operations.

Chapter 11 explains the importance of corporate governance internationally and the role of auditing in enhancing it. This chapter discusses the meaning of corporate governance and both external and internal auditing issues as they relate to corporate governance. Chapter 11 also describes international diversity in external auditing and the international harmonization of auditing standards.

Chapter 12 introduces sustainability reporting, a system of measuring and disclosing an entity's social and environmental performance using well-defined, internationally agreed-upon standards. Sustainability reporting is now required of all large companies in the European Union. Elsewhere, most large companies voluntarily publish annual sustainability reports that are analogous to traditional financial reports. Chapter 12 describes the structure of the sustainability reporting system, including the Global Reporting Initiative at the international level and the Sustainability Accounting Standards Board in the United States.

CHANGES IN THE FIFTH EDITION

Chapter 1

- Updated statistics in the section titled "The Global Economy."
- Updated end-of-chapter assignments based on annual reports and replaced other dated material with the most current information available.

Chapter 2

- Updated examples of accounting diversity drawn from corporate annual reports and added several new companies to provide examples of accounting diversity.
- Moved the discussion of national culture as an influence on accounting to the section titled "Reasons for Accounting Diversity" and added a subsection describing a modification to Gray's cultural accounting framework.
- Deleted the paragraphs related to religion and accounting in the section titled "Reasons for Accounting Diversity."
- Retitled the section "Accounting Clusters" as "Classification of Accounting Systems."
- Streamlined the previous section "Empirical Test of the Judgmental Classification," making it a subsection within "Classification of Accounting Systems."
- Added several new questions and one new exercise to the end-of-chapter assignments.

Chapter 3

- Updated annual reports excerpts from various companies.
- Discussed FASB and IASB joint project for developing common conceptual framework and its current status and future prospects.
- Added new questions and new exercises and problems to the end-of-chapter material.

Chapter 4

- Updated the section on inventories to reflect the convergence of U.S. GAAP to the lower of cost or net realizable value rule.
- Substantially expanded the discussion of investment property.
- Added a section on biological assets.
- Expanded the discussion of intangible assets to provide an extensive discussion of the capitalization of development costs in the auto industry.
- Moved material on business combinations and consolidation from Chapter 9 (in the fourth edition) to this chapter.
- Added and/or modified problems to reflect the above changes.

Chapter 5

- Moved the section on disclosure and presentation standards from Chapter 4 (in the fourth edition) to this chapter.

- Moved the section on leases from Chapter 4 (in the fourth edition) to this chapter and updated the section to reflect the introduction of IFRS 16, *Leases,* in 2019.
- Revised the Revenue Recognition section to reflect the introduction of IFRS 15, *Revenue from Contracts with Customers.*
- Revised the Financial Instruments section to reflect the introduction of IFRS 9, *Financial Instruments.*
- Added and/or modified problems to reflect the above changes.

Chapter 6

- Updated annual report excerpts and the related discussions.
- Updated Exhibits 6.1 and 6.2 and related discussions to provide recent exchange rates.
- Added information on IFRS 9, *Financial Instruments.*
- Updated Case 6-2 to be based on more recent exchange rates.
- Added new Case 6-3, Jaguar Land Rover.
- Introduced Brexit example and discussed the consequences for UK firms related to sudden devaluation of the British pound without proper hedging.

Chapter 7

- Updated annual report excerpts and related discussions.
- Deleted discussion of the current/noncurrent and monetary/nonmonetary methods of translation.
- Added an appendix that covers the translation of foreign currency financial statements in hyperinflationary economies.
- Added new questions and exercises and problems related to the new appendix.
- Replaced several exercises and problems with new ones covering similar learning objectives.

Chapter 8

- Rearranged several sections in the chapter: "Tax Treaties" now precedes "Controlled Foreign Corporations," which now precedes "Foreign Tax Credits."
- Updated information regarding income, withholding, and treaty tax rates in several exhibits and updated Case 8-1 to reflect changes in these rates.
- Added information on the use of tax havens, especially by U.S. companies, to lower worldwide taxes.
- Added information on "participation exemption" systems within the section titled "Tax Jurisdiction."
- Added a subsection on "Relief from Double Taxation" within the section titled "Tax Jurisdiction."
- Added a section titled "OECD Base Erosion and Profit Shifting Action Plan."
- Updated the section "U.S. Tax Treatment of Foreign Operation Income" based on the new U.S. tax law effective in 2018 (Tax Cuts and Jobs Act of 2017).
- Added a section titled "U.S. Tax Reform 2017: Other International Tax Provisions."
- Deleted the section titled "Tax Incentives."
- Deleted an end-of-chapter question related to tax incentives and added questions related to the OECD action plan and the foreign housing costs exclusion.
- Updated end-of-chapter assignments for the change in U.S. corporate income tax rates brought about by the new U.S. tax law.
- Added questions and exercises and problems related to the international tax provisions in the new U.S. tax law.

Chapter 9

- Updated statistics related to the extent of international intercompany transfers, the use of various transfer pricing methods, and the use of advance pricing agreements.
- Deleted the subsection "Survey Results" within the section titled "Objectives of International Transfer Pricing."
- Added the subsection "OECD Country-by-Country Reporting" in the "Government Reactions" section and added the subsection "Country-by-Country Reporting" in the "U.S. Transfer Pricing Rules" section.
- Added a subsection related to use of the comparable profits method for licenses of intangible property within the "U.S. Transfer Pricing Rules" section.
- Updated information on the "Enforcement of Transfer Pricing Regulations" by the United States.

Chapter 10

- Removed much of the content related to corporate strategy to focus more specifically on management accounting issues.
- Retitled the chapter, "Management Accounting Issues in Multinational Corporations."
- Reorganized content into the following sections: "Capital Budgeting," "Management Control Systems," "Performance Evaluation," "Operational Budgeting," and "Culture and Management Control."
- Streamlined the discussion of various capital budgeting techniques to focus on net present value.
- Deleted the subsection related to the balanced scorecard.

- Deleted end-of-chapter material related to corporate strategy and other content removed from the chapter.
- Added several questions and exercises and problems covering the management accounting issues emphasized in the chapter.

Chapter 11

- Added new Introduction focused on corporate governance.
- Changed the title of the chapter to "Auditing and Corporate Governance: An International Perspective" and rearranged the sections with a focus on the new title.
- Updated most exhibits throughout the chapter and in Cases 11-1 and 11-2.

Chapter 12

- Changed the title of the chapter to "International Sustainability Reporting."
- Added a discussion of investors' increasing demands for sustainability information.
- Updated the discussion of the Global Reporting Initiative to reflect the introduction of GRI standards in June 2018.
- Added a discussion of nonfinancial materiality.
- Added a discussion of the mission of the Sustainability Accounting Standards Board to the section titled "Toward Mandatory Sustainability Reporting."
- Added a discussion of the climate change disclosures required by the U.S. SEC in the Form 10-K to the section "Toward Mandatory Sustainability Reporting."
- Revised the discussion of climate change to focus specifically on the Greenhouse Gas Protocol's system of measuring carbon dioxide equivalent emissions.
- Updated examples of sustainability reporting practices at MNCs, replacing prior examples with selections from the sustainability reports of Mazda, Baxter International, IKEA, and ExxonMobil.

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NEW for the 5th edition, *International Accounting* is accompanied by Connect, McGraw-Hill's teaching and learning platform. Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. End of chapter material has been incorporated in Connect.

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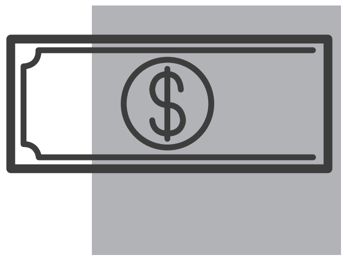

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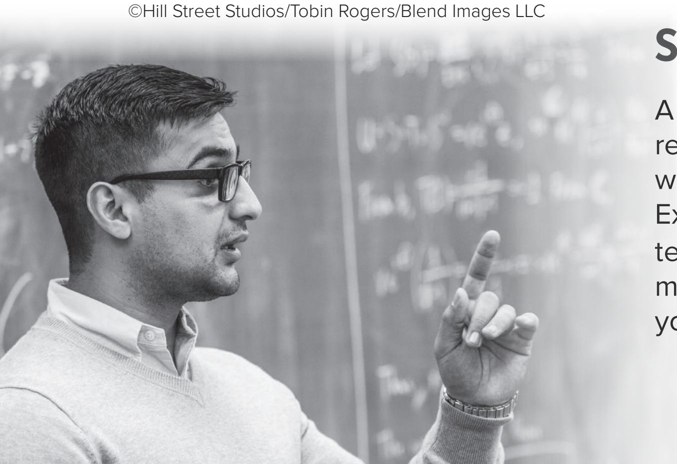

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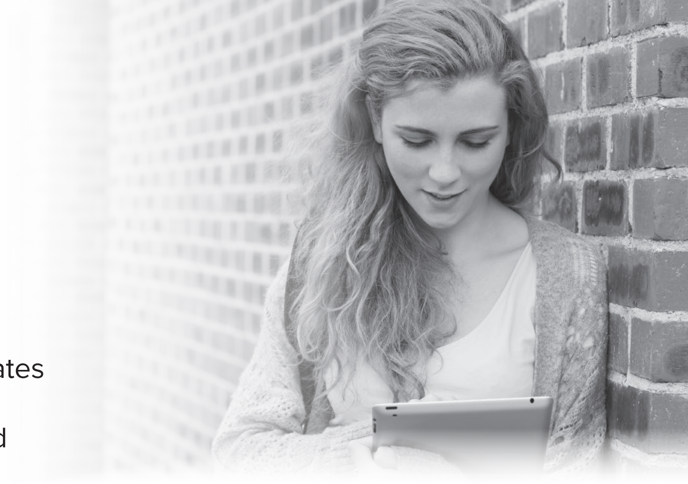

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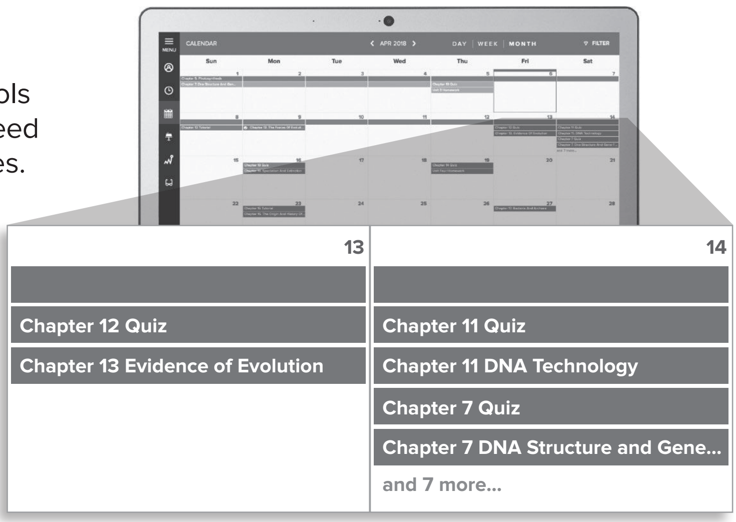

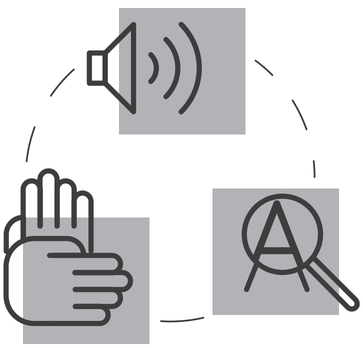

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Brief Contents

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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.
- Understand the importance of international trade, foreign direct investment, and multinational corporations in the global economy.

INTRODUCTION

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 reporting, managerial accounting, auditing, and taxation.

The word *international* in international accounting can be defined at three different levels.[1] At the *first 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 rules related to the financial reporting of property, plant, and equipment; income and other tax rates; and the requirements for becoming a member of the national accounting profession.

At the *second level* is supranational accounting, which denotes standards, guidelines, and rules of financial reporting, auditing, and taxation issued by supranational organizations.

[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).

Such organizations include the International Accounting Standards Board (IASB), the International Federation of Accountants (IFAC), and the Organization for Economic Cooperation and Development (OECD).

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

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. This book is designed to be used in a course that provides an overview of the broadly defined area of international accounting, including certain supranational guidelines, but that focuses on the accounting issues related to international business activities and foreign investments. In other words, this book focuses on international accounting issues at the company level that are specifically relevant to multinational corporations.[2]

The next section of this chapter introduces accounting issues that are important to multinational corporations by describing the evolution of a fictitious company as it becomes increasingly more multinational. To provide justification for the importance of these issues, the following section highlights the importance of international trade, foreign direct investment, and multinational corporations in the global economy. The final section of this chapter summarizes the major topics covered in this book.

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.[3] 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 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,

[2] There is no universally accepted definition of a multinational corporation. Rugman and Collinson (2012, p. 7) define a multinational corporation as a company that is headquartered in one country but has operations in other countries. The United Nations (1973, p. 23) defines multinational corporations as "enterprises which own or control production or service facilities outside the country in which they are based."

[3] 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.

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 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$1.35, the journal entry would have been:

Dr. Accounts Receivable (£) (+ Assets)	US$135,000	
Cr. Sales Revenue (+ Equity)		US$135,000

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$1.30, and the £100,000 received by Magnum was converted into US$130,000. The partial journal entry to record this would have been:

Dr. Cash (+ Asset)	US$130,000	
Cr. Accounts Receivable (£) (– Asset)		US$135,000

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$5,000 between the original US$ 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 is obliged to accept payment in the foreign currency. Thus, foreign exchange risk arises.

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$135,000 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,[4] 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) of future cash flows 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; this is even more true when the investment is being made in a foreign country.

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, 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

[4] 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.

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.[5] 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 net income. Each country has 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.

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

[5] Note that in 2005, in compliance with European Union regulations, Portugal adopted International Financial Reporting Standards for publicly traded (that is, stock exchange listed) companies. However, as a wholly-owned subsidiary of a U.S. parent company, Espelho Ltda. continues to use Portuguese GAAP in keeping its books.

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 financial accounting rules, each country also has a unique set of tax regulations.

As a Portuguese corporation doing business in Portugal, Espelho Ltda. is required 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. At the time Magnum acquired Espelho, the United States taxed corporate profits on a worldwide basis, which meant that Magnum also has 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 was not owed until Espelho's income was 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 foreign operations can be subject to double taxation.[6]

Some home countries provide parent companies with foreign operations 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. Other countries eliminate double taxation by exempting income earned by foreign operations from corporate income taxation. Magnum's tax accountants must be very conversant in both U.S. and foreign tax laws as it pertains to foreign income to make sure that the company is not paying more taxes worldwide 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. Automobile 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 lower than that in the United States, Magnum requires these parts to be sold to Espelho at as low a price as possible. Transferring parts to Portugal at low prices shifts gross profit to Portugal that otherwise would be earned in the United States, thus reducing the total taxes paid across both countries. Most governments are aware that multinational companies have the ability to shift profits from high-tax countries to low-tax 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

[6] In 2018, the United States abandoned its worldwide approach in favor of a territorial approach to taxing foreign source income. Beginning that year, income earned by foreign subsidiaries of U.S. companies was no longer subject to U.S. corporate income taxation. However, income earned by foreign branches of U.S. companies remains taxable in the United States.

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 also must decide whether reported results should be adjusted to factor out those items over which Espelho's managers have no control, such as the artificially low price paid for plastic parts imported from Magnum. There are no universally correct solutions to the various issues that Magnum must address in evaluating performance, 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 should 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 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

EXHIBIT 1.2
The History of KPMG

Source: KPMG, home.kpmg.com/in/en/home/about/overview/history.html, accessed June 1, 2017.

KPMG was formed in 1987 with the merger of Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG) and their individual member firms. Spanning three centuries, the organization's history can be traced through the names of its principal founding members—whose initials form the name "KPMG."

- **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.

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.

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

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.

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). Each of the Big Four firms, Deloitte Touche Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers, has offices in more than 150 countries and territories 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 statements. Regulations pertaining to foreign companies can differ from those for domestic companies. For example, in the United States, the Securities and Exchange Commission (SEC) requires all U.S. companies to use U.S. GAAP in preparing their financial statements. Foreign companies listed on U.S. stock exchanges may use foreign GAAP in preparing their financial statements but generally must provide a reconciliation of net income and stockholders' equity to U.S. GAAP. In 2007, the U.S. SEC relaxed this requirement for those foreign companies that use International Financial Reporting Standards (IFRS) to prepare financial statements.

Many stock exchanges around the world now allow foreign companies to be listed on those exchanges by using IFRS developed by the IASB. Magnum determined that by preparing a set of financial statements based on IFRS, it could gain access to most of the stock exchanges it might possibly want to, including London's and Hong Kong's. With the help of its external auditing firm, Magnum's accountants developed a second set of financial statements prepared in accordance with IFRS, and the company was able to obtain stock exchange listings in several foreign countries.

Sustainability Reporting

As Magnum's managers became more internationally oriented, they discovered that several automotive firms located in foreign countries provide information on their corporate websites related to *sustainability*. In addition to an annual financial report containing traditional financial statements, many companies today prepare a separate report that provides the company's stakeholders with information on the company's sustainability strategy and the progress made in meeting sustainability objectives. Although companies give these reports various names such as *Sustainable Value Report* or *Corporate Responsibility Report,* most commonly they are simply titled *Sustainability Report.* Sustainability reports tend to provide information on issues such as environmental impact, labor practices, product safety, and innovation. In many cases, companies prepare and publish these reports voluntarily, but sustainability disclosures are actually required in several countries. Seeing a potential benefit to providing stakeholders with this type of information, Magnum's management team developed the framework for a corporate responsibility and sustainability report and began to voluntarily provide this information on the company's website.

Global Accounting Standards

Through their experiences in analyzing the financial statements of potential acquisitions and in cross-listing the company's stock, Magnum's managers began to wonder whether the differences that exist in GAAP across countries were really necessary. There would be significant advantages if all countries, including the United States, were to adopt a common set of accounting rules. In that case, Magnum could use one set of accounting standards as the local GAAP in each of the countries in which it has operations and thus avoid the GAAP conversion that it currently must perform in preparing consolidated financial statements. It also could use one set of financial statements to facilitate obtaining financing in different countries. In addition, a single set of accounting rules used worldwide would significantly reduce the problems the company had experienced over the years in evaluating foreign investment opportunities based on financial statements prepared in compliance with a variety of local GAAP. Over time, Magnum Corporation became a strong proponent of global accounting standards.

THE GLOBAL ECONOMY

Although Magnum is a fictitious company, its evolution into a multinational corporation is not unrealistic. Most companies begin by selling their products in the domestic market. As foreign demand for the company's product arises, this demand is met initially through making export sales. Exporting is the entry point for most companies into the world of international business.

International Trade

International trade (imports and exports) constitutes a significant portion of the world economy. In 2016, companies worldwide exported more than $15.9 trillion worth of merchandise.[7] The three largest exporters were China, the United States, and Germany, in that order. The United States, China, and Germany, in that order, were the three largest importers. Although international trade has existed for thousands of years, recent growth in trade has been phenomenal. Over the period 2006–2016, U.S. exports increased from $1,026 billion to $1,455 billion per year, a 42 percent increase. During the same period, Chinese exports more than doubled to $2,098 billion in 2016.[8]

The number of companies involved in trade also has grown substantially. The number of U.S. companies making export sales rose by 233 percent from 1987 to 1999, when the number stood at 231,420.[9] In 2015, 407,753 U.S. companies were involved in international trade.[10] The Boeing Company is a U.S.-based aerospace company with billions of dollars of annual export sales. In 2016, 59 percent ($56 billion) of the company's sales were outside of the United States. In addition, some of the company's key suppliers and subcontractors are located in Europe and Japan. However, not only large companies are involved in exporting. Companies with fewer than 500 workers comprise more than 95 percent of U.S. exporters.[11]

Foreign Direct Investment

The product cycle theory suggests that, as time passes, exporters might believe the only way to retain their advantage over competition in foreign markets is to produce locally, thereby reducing transportation costs. Companies often acquire existing operations in foreign countries as a way to establish a local production capability. Alternatively, companies can establish a local presence by founding a new company specifically tailored to the company's needs. Sometimes this is done through a joint venture with a local partner.

The acquisition of existing foreign companies and the creation of new foreign subsidiaries are the two most common forms of what is known as foreign direct investment (FDI). The growth in FDI can be seen in Exhibit 1.3. The tremendous increase in the total stock of FDI from 1990 to 2016 is partially attributable to the liberalization of investment laws in many countries specifically aimed at attracting FDI. In 2015, 85 percent of changes in national FDI laws were favorable for foreign investors.[12]

FDI plays a large and important role in the world economy. Global sales of foreign affiliates were about 2.4 times as high as global exports in 2016, compared to almost parity in 1982. Global sales of foreign affiliates in 2016 made up approximately one-half of worldwide gross domestic product.

In 2016, there were 68 cross-border acquisitions of existing companies in which the purchase price exceeded $3 billion. The largest deal was the acquisition of SABMiller PLC, a British company, by Anheuser Busch/Inbev SA/NV, a Belgian beverages firm, for a reported $101.5 billion.[13] More than 14,000 FDI greenfield and expansion projects were

[7] World Trade Organization, *World Trade Statistical Review 2017,* Table A.6, Leading Exporters and Importers in World Merchandise Trade, 2016.

[8] World Trade Organization, *World Trade Statistical Review 2017,* Table A.58, World Merchandise Exports by Region and Selected Economy, 2006–2016.

[9] U.S. Department of Commerce, International Trade Administration, "Small and Medium-Sized Enterprises Play an Important Role," *Export America,* September 2001, pp. 26–29.

[10] U.S. Department of Commerce, International Trade Administration, *U.S. Exporting & Importing Companies 2015,* April 2017.

[11] U.S. Department of Commerce, International Trade Administration, *U.S. Exporting & Importing Companies 2015,* April 2017.

[12] United Nations, *World Investment Report 2016,* p. xi.

[13] United Nations, *World Investment Report 2017,* Annex Table 5.

EXHIBIT 1.3 Growth in Foreign Direct Investment, 1990–2016

Source: United Nations, *World Investment Report 2017,* Table I.4.

	(Billions of dollars)				
Item	**1990**	**2005–2007 Precrisis Average**	**2014**	**2015**	**2016**
FDI inflows	$ 207	$ 1,418	$ 1,277	$ 1,762	$ 1,746
FDI outflows	241	1,445	1,318	1,474	1,452
FDI inward stock	2,077	14,500	25,113	24,983	26,728
FDI outward stock	2,091	15,104	24,810	25,045	26,160
Sales of foreign affiliates	5,101	20,355	34,149	36,668	37,570
Total assets of foreign affiliates	4,595	40,924	101,254	105,778	112,833
Employment by foreign affiliates (thousands)	$21,454	49,565	76,821	79,505	82,140
Gross domestic product	22,327	51,288	77,807	73,152	75,259

announced in 2016. The United States was the leading location of these projects, followed by Germany and the United Kingdom.[14]

The extent of foreign corporate presence in a country can be viewed by looking at the cumulative amount of inward FDI. Over the period 1990–2016, the United States received more FDI ($6.39 trillion) than any other country. The United States also had the largest amount of outbound FDI ($6.38 trillion) during this period.[15]

Multinational Corporations

A multinational corporation is a company that is headquartered in one country but has operations in other countries.[16] In 2009, the United Nations estimated that there were more than 82,000 multinational companies in the world, with more than 810,000 foreign affiliates.[17] The 100 largest multinational companies accounted for approximately 4 percent of the world's GDP.[18]

Companies located in a relatively small number of countries conduct a large proportion of international trade and investment. These countries include the "triad"—the United States, Japan, and the European Union—that collectively dominated the world economy until the 1990s. More recently, China has emerged as a major player in the world economy. As Exhibit 1.4 shows, the triad countries plus China are home to the vast majority of the 100 largest companies in the world.

In 2016, the United Nations measured the multinationality of companies by averaging 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. Exhibit 1.5 lists the top 10 nonfinancial companies according to this multinationality index (MNI). Rio Tinto PLC was the most multinational company in the world, with more than 99 percent of its assets, sales, and employees located outside its home country of the United Kingdom. Nine of

[14] United Nations, *World Investment Report 2017,* Web Annex Table 21.

[15] United Nations, *World Investment Report 2017,* Web Annex Tables 3 and 4.

[16] As noted earlier, there is no universally accepted definition of a multinational corporation. The definition used here comes from Alan M. Rugman and Simon Collinson, *International Business,* 6th ed. (Essex, England: Pearson Education Limited, 2012), p. 7.

[17] United Nations, *World Investment Report 2009,* p. 17.

[18] United Nations, *World Investment Report 2009,* p. 17.

EXHIBIT 1.4
Home Country of Largest 100 Companies by Revenues, 2016

Source: Fortune Global 500, available at fortune.com/global500/, accessed on September 5, 2017.

"Triad" Countries		**Other Countries**	
United States	38	South Korea	3
Japan	8	Switzerland	2
European Union		Brazil	1
Germany	8	Russia	1
France	7	Singapore	1
United Kingdom	5	Taiwan	1
Netherlands	3		9
Italy	2		
Spain	1		
	72		
China	19		
	91		

the ten companies on this list are headquartered in Europe, with 40 percent located in the United Kingdom alone. The five most multinational U.S. companies in 2016, in order, were Mondelez, IBM, Coca-Cola, Schlumberger, and Johnson & Johnson.

Many companies have established a worldwide presence. U.S.-based Nike Inc., the world's largest manufacturer of athletic footwear, apparel, and equipment, has branch offices and subsidiaries in 51 countries, sells products in virtually all countries, and has more than 70,000 employees around the globe. Almost all of Nike's footwear and apparel products are manufactured outside of the United States. The company generates approximately 53 percent of its sales outside of North America.[19]

Unilever is a diversified company with co-headquarters in the Netherlands and the United Kingdom. In addition to its stock being listed on exchanges in its home countries, Unilever's shares also are listed on the New York Stock Exchange in the United States. The company operates in more than 190 countries around the world and has principal subsidiaries in countries like Argentina, Australia, India, Japan, Mexico, and the United States, among others. Unilever uses the euro as its reporting currency in presenting financial statements. Because

EXHIBIT 1.5 **The World's Top 10 Nonfinancial Companies in Terms of Multinationality, 2016**

Source: United Nations, *World Investment Report 2017,* Web Annex Table 24.

Corporation	Country	Industry	MNI*
Rio Tinto PLC	United Kingdom	Mining, quarrying and petroleum	99.3
John Swire & Sons Limited	United Kingdom	Transport and storage	98.8
Altice NV	Netherlands	Telecommunications	97.0
Broadcom Limited	Singapore	Electronic components	96.4
Anglo American PLC	United Kingdom	Mining, quarrying and petroleum	96.0
Nokia OY	Finland	Communications equipment	94.4
SAP SE	Germany	Computer and data processing	92.5
Nestlé SA	Switzerland	Food and beverages	92.5
Shire PLC	Ireland	Pharmaceuticals	91.9
Liberty Global PLC	United Kingdom	Telecommunications	91.6

* Multinationality index (MNI) is calculated as the average of three ratios: foreign assets/total assets, foreign sales/total sales, and foreign employment/total employment.

[19] Nike Inc., 2016 Form 10-K, various pages.

many of its subsidiaries are located outside of the euro zone, Unilever must translate the financial statements from these operations into euros for consolidation purposes. Unilever's management notes that it uses foreign currency borrowings and forward contracts as hedges of the currency risk associated with net investments in foreign subsidiaries.[20]

International Capital Markets

Many multinational corporations have found it necessary, for one reason or another, to have their stock cross-listed on foreign stock exchanges. Large companies in small countries, such as Finland's Nokia OY, might find this necessary to obtain sufficient capital at a reasonable cost. Nokia's shares are listed on the Helsinki, Paris, and New York stock exchanges. Other companies obtain a listing on a foreign exchange to have an "acquisition currency" for acquiring firms in that country through stock swaps. Several years after obtaining an NYSE listing in 1993, Germany's Daimler-Benz acquired Chrysler in the United States through an exchange of shares. The resulting DaimlerChrysler merger was short-lived, however, with Daimler selling its investment in Chrysler in 2007.

On September 30, 2017, there were 490 foreign companies from 46 countries cross-listed on the NYSE.[21] More than one-quarter of these companies are Canadian. Likewise, a number of U.S. companies are cross-listed on non-U.S. stock exchanges. For example, approximately 20 U.S. companies are listed on the London Stock Exchange, including Boeing, General Electric, and Marsh & McLennan. U.S. companies such as AbbVie, Caterpillar, and Procter & Gamble are listed on the Euronext Paris stock exchange.

OUTLINE OF THE BOOK

The evolution of the fictitious Magnum Corporation presented in this chapter highlights many of the major accounting issues that a multinational corporation must address and that form the focus for this book. The remainder of this book is organized as follows.

Chapters 2 and 3 focus on differences in financial reporting across countries and the worldwide convergence of financial reporting standards. Chapter 2 provides evidence of the diversity in financial reporting that has existed internationally, explores the reasons for that diversity, and describes the various attempts to classify countries by accounting system. Chapter 3 describes and evaluates the major efforts to converge accounting internationally. The most important player in the development of global financial reporting standards is the IASB. Chapter 3 describes the work of the IASB and introduces IFRS.

Chapters 4 and 5 describe and demonstrate the requirements of selected IASB standards through numerical examples. In addition to describing the guidance provided by IFRS, these chapters provide comparisons with U.S. GAAP to indicate the differences and similarities between the two sets of standards. Chapter 4 focuses on IFRS related to the recognition and measurement of assets, specifically inventories; property, plant, and equipment; investment property; biological assets; and intangibles and goodwill. This chapter also covers business combinations and consolidated financial statements, and borrowing costs. Chapter 5 covers IFRS related to current liabilities, provisions, employee benefits, share-based payment, income taxes, revenue, financial instruments, and leases. IFRS that deal exclusively with disclosure and presentation issues also are briefly summarized.

[20] Unilever N.V., Annual Report and Accounts 2016, various pages.

[21] New York Stock Exchange, *Current List of All Non-U.S. Issuers,* accessed at www.nyse.com on October 27, 2017.

Chapters 6 and 7 focus on financial reporting issues that are of particular relevance to international business operations (international trade and foreign direct investments). Chapter 6 covers the accounting for international transactions that are denominated in a foreign currency (foreign currency transactions) as well as the accounting for hedges used to minimize the risk associated with these transactions arising from changes in exchange rates (hedges of foreign exchange risk). Chapter 7 demonstrates the translation of foreign currency financial statements of foreign operations for the purpose of preparing consolidated financial statements. An appendix to Chapter 7 covers the translation of financial statements when the foreign operation is located in a hyperinflationary country. Chapters 6 and 7 focus on IFRS and U.S. GAAP related to these topics.

Chapters 8 and 9 cover the topics of international taxation and international transfer pricing. Chapter 8 provides an overview of corporate income taxation worldwide and then focuses on the taxation of foreign operation income by the home country government. A working knowledge of international taxation issues is important for all students of international business and accounting, not only for tax specialists. Chapter 9 covers the topic of international transfer pricing, focusing on tax implications. This chapter describes rules established by national governments to counteract multinational corporations' use of international transfer pricing to reduce income taxes, with an emphasis on the rules imposed by the U.S. government. These rules are relevant not only for U.S. multinational corporations, but also for foreign corporations that have subsidiaries in the United States.

Chapter 10 focuses on managerial accounting issues of particular relevance to multinational corporations. This chapter covers multinational capital budgeting as a vital component of strategy formulation and operational budgeting as a key ingredient in strategy implementation. Chapter 10 also describes issues that must be addressed in designing a process for evaluating the performance of foreign operations.

Chapter 11 covers auditing and corporate governance from an international perspective. This chapter discusses both external and internal auditing issues as they relate to corporate governance in an international context. Chapter 11 also describes international diversity in external auditing, International Standards on Auditing, and the international harmonization of auditing standards.

Chapter 12 introduces sustainability reporting, a system of measuring and disclosing an entity's social and environmental performance using well-defined, internationally agreed-upon standards. Sustainability reporting is now required of all large companies in the European Union. Elsewhere, most large companies voluntarily publish annual sustainability reports that are analogous to traditional annual financial reports. Chapter 12 describes the structure of the sustainability reporting system, including the work of the Global Reporting Initiative at the international level and the Sustainability Accounting Standards Board in the United States.

Summary

1. International accounting is an extremely broad topic. At a minimum, it focuses on the accounting issues unique to multinational corporations. At the other extreme, it includes the study of the various functional areas of accounting (financial, managerial, auditing, and taxation) in all countries of the world, as well as a comparison across countries. This book focuses on the accounting issues encountered by multinational companies engaged in international trade and making foreign direct investments and also includes coverage of certain supranational guidelines that are relevant for multinationals.
2. The world economy is becoming increasingly more integrated. International trade (imports and exports) has grown substantially in recent years and has even become a normal part of business for relatively small companies.

3. The tremendous growth in FDI over the last several 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 outstrip the revenues generated through exporting by a more than two-to-one margin.
4. There are tens of thousands of multinational companies in the world. A disproportionate number of the largest multinational corporations are headquartered in the United States, China, Japan, and the European Union.
5. According to the United Nations, 9 of the top 10 most multinational nonfinancial companies in the world in 2016 were headquartered in Europe, with 4 of these companies located in the United Kingdom.
6. In addition to establishing operations overseas, many multinational companies also cross-list their shares on stock exchanges outside of their home country. There are a number of reasons for doing this, including gaining access to a larger pool of capital.
7. The remainder of this book consists of 11 chapters. Six chapters (Chapters 2–7) deal primarily with financial accounting and reporting issues. Chapters 8 and 9 focus on international taxation and transfer pricing. Chapter 10 deals with management accounting issues specifically relevant to multinational corporations. Chapter 11 provides an international perspective on auditing and corporate governance. The final chapter, Chapter 12, provides an introduction to sustainability reporting at the international level.

Questions

1. How important is international trade (imports and exports) to the world economy?
2. What accounting issues arise for a company as a result of engaging in international trade (imports and exports)?
3. Why might a company be interested in investing in an operation in a foreign country (foreign direct investment)?
4. How important is foreign direct investment to the world economy?
5. What financial reporting issues arise as a result of making a foreign direct investment?
6. What taxation issues arise as a result of making a foreign direct investment?
7. What are some of the issues that arise in evaluating and maintaining control over foreign operations?
8. Why might a company want its stock listed on a stock exchange outside of its home country?
9. Where might one find information that could be used to measure the “multinationality” of a company?
10. What would be the advantages of having a single set of financial reporting standards used worldwide?

Exercises and Problems

1. Sony Corporation, headquartered in Tokyo, Japan, is one of the largest multinational companies in the world. While Sony’s financial reporting currency is the Japanese yen, the company’s foreign subsidiaries keep books in a variety of different currencies including the British pound, Euro, Indian rupee, Mexican peso, and U.S. dollar. In addition, Sony engages in international transactions denominated in currencies other than

the yen. As a result, Sony must translate foreign currency receivables and payables and also must translate each foreign subsidiary's financial statements into Japanese yen to prepare consolidated financial statements.

Sony is one of the foreign companies listed on the NYSE, and therefore files an annual report on Form 20-F with the U.S. SEC each year.

Required:

a. Access Sony Corporation's Form 20-F for the fiscal year ended March 31, 2017, available on the SEC's EDGAR website at https://www.sec.gov/Archives/edgar/data/313838/000119312517203939/d358485d20f.htm, and refer to "Translation of foreign currencies" in the "Summary of significant accounting polices" on page F-15.

b. Explain in your own words the policies that Sony uses to reflect the impact of changes in foreign exchange rates in its consolidated financial statements.

2. Cooper Grant is the president of Acme Brush of Brazil, the wholly-owned Brazilian subsidiary of U.S.-based Acme Brush Inc. Cooper Grant's compensation package consists of a combination of salary and bonus. His annual bonus is calculated as a predetermined percentage of the pretax annual income earned by Acme Brush of Brazil. A condensed income statement for Acme Brush of Brazil for the most recent year is as follows (amounts in thousands of Brazilian reals [BRL]):

Sales	BRL 10,000
Expenses	9,500
Pretax income	BRL 500

After translating the Brazilian real income statement into U.S. dollars, the condensed income statement for Acme Brush of Brazil appears as follows (amounts in thousands of U.S. dollars [US$]):

Sales	US$3,000
Expenses	3,300
Pretax income (loss)	US$ (300)

Required:

a. Explain how Acme Brush of Brazil's pretax income (in BRL) became a U.S.-dollar pretax loss.

b. Discuss whether Cooper Grant should be paid a bonus or not.

3. The NYSE provides a list of non-U.S. companies listed on the exchange on its website (www.nyse.com). (Hint: Search the Internet for "NYSE Current List of All Non-U.S. Listed Issuers.")

Required:

a. Determine the number of foreign companies listed on the NYSE and the number of countries they represent.

b. Determine the five countries with the largest number of foreign companies listed on the NYSE.

c. Speculate as to why non-U.S. companies have gone to the effort to have their shares listed on the NYSE.

4. The London Stock Exchange (LSE) provides a list of companies listed on the exchange on its website (www.londonstockexchange.com) under "Statistics" and "Companies and Securities."

Required:

a. Determine the number of foreign companies listed on the LSE and the number of countries they represent.

b. Determine the number of companies listed on the LSE from these countries: Australia, Brazil, Canada, France, Germany, Mexico, and the United States. Speculate as to why there are more companies listed on the LSE from Australia and Canada than from France and Germany.

5. Volkswagen AG and Daimler AG, both based in Germany, are two of the largest automobile manufacturers in the world. The following information was provided in each company's 2016 annual report.

Required:

Calculate an index of multinationality based upon the geographical distribution of sales revenue and noncurrent assets (employee information is not available) to determine which of these two companies is more multinational.

VOLKSWAGEN AG
2016 Annual Report

	Sales revenue from external customers*	Intangible assets, property, plant and equipment, lease assets and investment property*
Germany	43,634	84,525
Europe/Other markets†	94,445	40,717
North America	35,454	23,958
South America	7,973	3,320
Asia-Pacific	35,761	3,064
Total	**217,267**	**155,583**

† Excluding Germany

* In millions of euros

DAIMLER AG
2016 Annual Report

In millions of euros	Revenue*	Noncurrent assets*
Europe	63,417	45,565
thereof Germany	23,509	34,981
NAFTA region	44,960	24,105
thereof United States	39,169	21,878
Asia	35,562	2,161
thereof China	15,984	100
Other markets	9,322	1,502
	153,261	**73,333**

* In millions of euros

Case 1-1

Besserbrau AG

Besserbrau AG is a German beer producer headquartered in Ergersheim, Bavaria. The company, which was founded in 1842 by brothers Hans and Franz Besser, is publicly traded, with shares listed on the Frankfurt Stock Exchange. Manufacturing in strict accordance with the almost 500-year-old German Beer Purity Law, Besserbrau uses only four ingredients in making its products: malt, hops, yeast, and water. While the other ingredients are obtained locally, Besserbrau imports hops from a company located in the Czech Republic. Czech hops are considered to be among the world's finest. Historically, Besserbrau's products were marketed exclusively in Germany. To take advantage of a potentially enormous market for its products and expand sales, Besserbrau began making sales in the People's Republic of China three years ago. The company established a wholly-owned subsidiary in China (BB Pijio) to handle the distribution of Besserbrau products in that country. In the most recent year, sales to BB Pijio accounted for 20 percent of Besserbrau's sales, and BB Pijio's sales to customers in China accounted for 10 percent of the Besserbrau Group's total profits. In fact, sales of Besserbrau products in China have expanded so rapidly and the potential for continued sales growth is so great that the company recently broke ground on the construction of a brewery in Shanghai, China. To finance construction of the new facility, Besserbrau negotiated a listing of its shares on the London Stock Exchange to facilitate an initial public offering of new shares of stock.

Required:

Discuss the various international accounting issues confronted by Besserbrau AG.

Case 1-2

Vanguard International Growth Fund

The Vanguard Group is an investment firm with more than 50 different mutual funds in which the public may invest. Among these funds are several international funds that concentrate on investments in non-U.S. stocks and bonds. One of these is the International Growth Fund. The following information about this fund was provided in the fund's prospectus, dated December 22, 2016.

VANGUARD INTERNATIONAL GROWTH FUND
Excerpts from Prospectus
December 22, 2016

Vanguard Fund Summary

Investment Objective

The Fund seeks to provide long-term capital appreciation.

Primary Investment Strategies

The Fund invests predominantly in the stocks of companies located outside the United States and is expected to diversify its assets across developed and emerging markets in Europe, the Far East, and Latin America. In selecting stocks, the Fund's advisors evaluate foreign markets around the world and choose large-, mid-, and small-capitalization companies considered to have above-average growth potential. The Fund uses multiple investment advisors.

Market Exposure

The Fund invests mainly in common stocks of non-U.S. companies that are considered to have above average potential for growth. The asset-weighted median market capitalization of the Fund as of August 31, 2016, was $34.4 billion.

The Fund is subject to investment style risk, which is the chance that returns from non-U.S. growth stocks and, to the extent that the Fund is invested in them, small- and mid-cap stocks, will trail returns from global markets. Historically, non-U.S. small- and mid-cap stocks have been more volatile in price than the large-cap stocks that dominate the global markets, and they often perform quite differently.

The Fund is subject to stock market risk, which is the chance that stock prices overall will decline. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices. The Fund's investments in foreign stocks can be riskier than U.S. stock investments. Foreign stocks tend to be more volatile and less liquid than U.S. stocks. The prices of foreign stocks and the prices of U.S. stocks may move in opposite directions.

The Fund is subject to country/regional risk and currency risk. Country/regional risk is the chance that world 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. Because the Fund may invest a large portion of its assets in securities of companies located in any one country or region, including emerging markets, the Fund's performance may be hurt disproportionately by the poor performance of its investments in that area. Currency risk is the chance that the value of a foreign investment, measured in U.S. dollars, will decrease because of unfavorable changes in currency exchange rates. Country/regional risk and currency risk are especially high in emerging markets.

The Fund is subject to manager risk, which is the chance that poor security selection will cause the Fund to underperform relevant benchmarks or other funds with a similar investment objective. In addition, significant investment in the consumer discretionary sector subjects the Fund to proportionately higher exposure to the risks of this sector.

PLAIN TALK ABOUT
International Investing

U.S. investors who invest abroad will encounter risks not typically associated with U.S. companies because foreign stock and bond markets operate differently from the U.S. markets. For instance, foreign companies and governments are not subject to the same accounting, auditing, legal, tax, and financial-reporting standards and practices as U.S. companies and the U.S. government, and their stocks and bonds may not be as liquid as those of similar U.S. entities. In addition, foreign stock exchanges, brokers, companies, bond markets, and dealers may be subject to less government supervision and regulation than their counterparts in the United States. These factors, among others, could negatively affect the returns U.S. investors receive from foreign investments.

Source: Vanguard International Growth Fund Prospectus, pp. 1–11.

The International Growth Fund's annual report for the year ended August 31, 2016, indicated that 97 percent of the fund's portfolio was invested in 132 non-U.S. stocks and 3 percent was in temporary cash investments. The allocation of fund net assets by region was as follows:

47.5% Europe
22.2% Emerging Markets
19.5% Pacific
9.0% North America
1.8% Middle East

Source: Vanguard International Growth Fund Annual Report, p. 10.

The sectors and individual countries in which the fund was invested are presented in the following tables:

Sector Diversification (% of equity exposure)	
Consumer discretionary	21.8%
Consumer staples	6.5
Energy	1.4
Financials	17.3
Health care	9.8
Industrials	10.8
Information technology	22.4
Materials	4.1
Other	2.0
Telecommunication services	3.9
Utilities	0.0

Source: Vanguard International Growth Fund Annual Report, p. 10.

Market Diversification (% of equity exposure)			
Europe		**Pacific**	
United Kingdom	11.4%	Japan	12.2%
Germany	9.2	Hong Kong	4.6
Spain	5.2	South Korea	2.2
Sweden	5.1	Other	0.5
France	4.2	Subtotal	19.5%
Switzerland	3.2	**Emerging Markets**	
Italy	2.6	China	16.2%
Denmark	2.5	India	2.6
Netherlands	1.7	Taiwan	1.1
Norway	1.3	Brazil	1.0
Other	2.0	Other	1.3
Subtotal	47.5%	Subtotal	22.2%
		North America	
		United States	7.2%
		Canada	1.8
		Subtotal	9.0%
		Middle East	
		Israel	1.8%

Source: Vanguard International Growth Fund Annual Report, p. 11.

Required:

1. Explain why an individual investor might want to invest in an international growth fund.
2. Describe the risks associated with making an investment in an international growth fund. Identify the risks that would be common to domestic and international funds and the risks that would be unique to an international fund.
3. Refer to the "Plain Talk About International Investing" box. Speculate as to how the fact that foreign companies are not subject to the same accounting, auditing, and financial reporting standards and practices as U.S. companies could negatively affect the returns U.S. investors receive from foreign investments.
4. Consider the allocation of fund assets by region. Speculate as to why the proportions of fund assets are distributed in this manner.
5. Consider the market diversification of fund assets. Identify the countries in which the fund is most heavily invested. Speculate as to why this might be the case. Are there any countries in which you would have expected the fund to be more heavily invested? Are there any countries in which you would have expected the fund to be invested and it is not?
6. Consider the sector diversification of fund assets. Identify the sectors in which the fund is most heavily invested. Speculate as to why this might be the case.

Chapter Two

Worldwide Accounting Diversity

Learning Objectives

After reading this chapter, you should be able to

- Provide evidence of the diversity that exists in accounting internationally.
- Describe the major factors that influence the development of national accounting systems and lead to cross-national accounting diversity.
- Explain the problems caused by accounting diversity.
- Describe attempts to classify countries by financial reporting system.
- Describe a simplified model of the reasons for international differences in financial reporting.
- Categorize accounting differences that exist internationally and provide examples of each type of difference.

INTRODUCTION

Historically, considerable differences have existed across countries in the preparation and presentation of financial statements. For example, companies in the United States following U.S. generally accepted accounting principles (GAAP) are not allowed to report property, plant, and equipment (PPE) at amounts greater than historical cost. In contrast, companies in the European Union (EU) and other countries using International Financial Reporting Standards (IFRS) may choose to report assets on the balance sheet at either historical cost or fair value. Both U.S. GAAP and Japanese GAAP stipulate that research and development costs must be expensed as incurred, whereas IFRS requires development costs to be capitalized as an intangible asset when certain conditions are met. Those Chinese companies following Chinese GAAP must use the direct method in preparing the statement of cash flows, whereas most companies in the United States and the EU use the indirect method.

Differences in accounting can result in significantly different amounts being reported on the balance sheet and income statement. In its 2010 Form 20-F annual report filed with the U.S. Securities and Exchange Commission (SEC), the South Korean telecommunications firm SK Telecom Company Ltd. described 19 significant differences between South Korean and U.S. accounting rules. Under South Korean GAAP, SK Telecom reported 2010 net income of 1,297 billion South Korean won (KRW). If SK Telecom had used U.S. GAAP in 2010, its net income would have been KRW 1,397 billion, approximately

8 percent larger than under South Korean GAAP.[1] Shareholders' equity as stated under South Korean GAAP was KRW 12,479 billion but would have been KRW 14,573 billion under U.S. GAAP, a 17 percent difference.[2]

This chapter presents evidence of accounting diversity, explores the reasons for that diversity, and describes the problems that are created by differences in accounting practice across countries. Historically, several major models of accounting have been used internationally, with clusters of countries following them. These also are described and compared in this chapter.

The final section of this chapter categorizes the types of differences in financial reporting that exist across countries and uses excerpts from annual reports to present examples of those differences. It should be noted that much of the accounting diversity that existed in the past has been eliminated as countries have abandoned their local GAAP in favor of IFRS issued by the International Accounting Standards Board (IASB).[3] This chapter provides both a historical and a current perspective on accounting diversity that should allow readers to more fully appreciate the international financial reporting convergence efforts described in the next chapter.

EVIDENCE OF ACCOUNTING DIVERSITY

Exhibits 2.1 and 2.2 present consolidated balance sheets for the British company Vodafone Group PLC and its U.S. counterpart Verizon Communications Inc. A quick examination of these statements shows several differences in format and terminology between the United Kingdom and the United States. Perhaps the most obvious difference is the order in which assets are presented. Whereas Verizon presents assets in order of liquidity, beginning with cash and cash equivalents, Vodafone presents assets in reverse order of liquidity, starting with goodwill. On the other side of the balance sheet, Vodafone presents its equity accounts before liabilities. In the equity section, "Called-up share capital" is the equivalent of the "common stock" account on the U.S. balance sheet. Vodafone includes "Provisions," which represent estimated liabilities related to restructurings, legal disputes, and asset retirements, in both current and noncurrent liabilities. This line item does not appear in the U.S. balance sheet. Similar to many British companies, Vodafone includes a column in its balance sheet in which the company indicates the note relating to many of the balance sheet line items. Verizon does not provide similar information in its balance sheet, and it is uncommon for U.S. firms to do so.

As is the norm for U.S. companies, Verizon includes only consolidated financial statements in its annual report. In addition to consolidated financial statements, Vodafone also includes the parent company's separate balance sheet in its annual report. This is shown in Exhibit 2.3. In the parent company balance sheet, investments in subsidiaries are not consolidated, but instead are reported as *Shares in Group undertakings* in the *Fixed assets* section. Liabilities are called *Creditors,* and receivables are *Debtors*. Note that *Debtors: amounts falling due after more than one year* are included among *Current assets*.

[1] As reported in SK Telecom's Form 20-F filed with the U.S. SEC, the largest adjustments from South Korean GAAP to U.S. GAAP related to "scope of consolidation" and the recognition of losses on "currency and interest rate swap."

[2] Note that SK Telecom adopted IFRS in 2011 and since then has not provided information on a South Korean GAAP or U.S. GAAP basis in its Form 20-F filed with the U.S. SEC.

[3] As will be discussed in Chapter 3, many countries now require publicly traded (that is, stock exchange–listed) companies to use IFRS in preparing their consolidated financial statements. However, many countries continue to have a national GAAP that must be used by private companies in preparing consolidated financial statements, as well as by publicly traded companies in preparing separate parent company financial statements.

EXHIBIT 2.1

VODAFONE GROUP PLC
Consolidated Statement of Financial Position

at 31 March

	Note	**31 March 2017 £m**	Restated 31 March 2016 £m
Noncurrent assets			
Goodwill	10	**26,808**	28,238
Other intangible assets	10	**19,412**	30,326
Property, plant and equipment	11	**30,204**	35,515
Investments in associates and joint ventures	12	**3,138**	479
Other investments	13	**3,459**	4,631
Deferred tax assets	6	**24,300**	28,306
Post employment benefits	26	**57**	224
Trade and other receivables	15	**4,569**	5,793
		111,947	133,512
Current assets			
Inventory	14	**576**	716
Taxation recoverable		**150**	1,402
Trade and other receivables	15	**9,861**	11,561
Other investments	13	**6,120**	5,337
Cash and cash equivalents	20	**8,835**	12,922
		25,542	31,938
Assets held for sale	7	17,195	3,657
Total assets		**154,684**	69,107
Equity			
Called-up share capital	18	**4,796**	4,796
Additional paid-in capital		**151,808**	151,694
Treasury shares		**(8,610)**	(8,777)
Accumulated losses		**(105,851)**	(95,683)
Accumulated other comprehensive income		**30,057**	31,295
Total attributable to owners of the parent		**72,200**	83,325
Noncontrolling interests		**1,525**	1,817
Put options over noncontrolling interests		**(6)**	(6)
Total noncontrolling interests		**1,519**	**1,811**
Total equity		**73,719**	85,136
Noncurrent liabilities			
Long-term borrowings	21	**34,523**	37,089
Deferred tax liabilities	6	**535**	564
Post employment benefits	26	**651**	565
Provisions	17	**1,130**	1,619
Trade and other payables	16	**1,737**	1,899
		38,576	41,736
Current liabilities			
Short-term borrowings	21	**12,051**	20,260
Taxation liabilities		**661**	683
Provisions	17	**1,049**	958
Trade and other payables	16	**16,834**	19,896
		30,595	41,797
Liabilities held for sale	7	11,794	438
Total equity and liabilities		**154,684**	169,107

EXHIBIT 2.2

VERIZON COMMUNICATIONS INC.
Consolidated Balance Sheets

(dollars in millions, except per share amounts)		
At December 31	**2016**	2015
Assets		
Current assets		
Cash and cash equivalents	**$ 2,880**	$ 4,470
Short-term investments	**—**	350
Accounts receivable, net of allowances of $845 and $882	**17,513**	13,457
Inventories	**1,202**	1,252
Assets held for sale	**882**	792
Prepaid expenses and other	**3,918**	2,034
Total current assets	**26,395**	22,355
Plant, property and equipment	**232,215**	220,163
Less accumulated depreciation	**147,464**	136,622
Plant, property and equipment, net	**84,751**	83,541
Investments in unconsolidated businesses	**1,110**	796
Wireless licenses	**86,673**	86,575
Goodwill	**27,205**	25,331
Other intangible assets, net	**8,897**	7,592
Noncurrent assets held for sale	**613**	10,267
Other assets	**8,536**	7,718
Total assets	**$244,180**	$244,175
Liabilities and Equity		
Current liabilities		
Debt maturing within one year	**$ 2,645**	$ 6,489
Accounts payable and accrued liabilities	**19,593**	19,362
Liabilities related to assets held for sale	**24**	463
Other	**8,078**	8,738
Total current liabilities	**30,340**	35,052
Long-term debt	**105,433**	103,240
Employee benefit obligations	**26,166**	29,957
Deferred income taxes	**45,964**	45,484
Noncurrent liabilities related to assets held for sale	**6**	959
Other liabilities	**12,239**	11,641
Equity		
Series preferred stock ($.10 par value; none issued)	**—**	—
Common stock ($.10 par value; 4,242,374,240 shares issued in each period)	**424**	424
Contributed capital	**11,182**	29,957
Reinvested earnings	**15,059**	11,246
Accumulated other comprehensive income	**2,673**	550
Common stock in treasury, at cost	**(7,263)**	(7,416)
Deferred compensation—employee stock ownership plans and other	**449**	428
Noncontrolling interests	**1,508**	1,414
Total equity	**24,032**	17,842
Total liabilities and equity	**$244,180**	$244,175

EXHIBIT 2.3

VODAFONE GROUP PLC
Company Statement of Financial Position

at 31 March

	Note	**2017 £m**	Restated 2016 £m
Fixed assets			
Shares in group undertakings	2	**83,991**	84,597
Current assets			
Debtors: amounts falling due after more than one year	3	**3,692**	4,328
Debtors: amounts falling due within one year	3	**217,590**	212,058
Other investments		**1,678**	1,991
Cash at bank and in hand	4	**322**	133
		223,282	218,510
Creditors: amounts falling due within one year	5	**(219,924)**	(216,648)
Net current assets		**3,358**	1,862
Total assets less current liabilities		**87,349**	86,459
Creditors: amounts falling due after more than one year	5	**(35,369)**	(32,164)
		51,980	54,295
Capital and reserves			
Called-up share capital	6	**4,796**	4,796
Share premium account		**20,379**	20,377
Capital redemption reserve		**111**	111
Other reserves		**4,385**	4,423
Own shares held		**(8,739)**	(8,906)
Profit and loss account		**31,048**	33,494
Total equity shareholders' funds		**51,980**	54,295

Many differences in terminology exist in the presentation of shareholders' equity (labeled *Capital and reserves*) in the parent company balance sheet. Additional paid-in capital is called *Share premium account,* treasury stock is titled *Own shares held,* and retained earnings are reflected in the line titled *Profit and loss account*. Perhaps most unusual from a U.S. perspective are the *Capital redemption reserve* and *Other reserves* line items. These accounts reflect appropriations of retained earnings and are virtually unknown in the United States. Appropriated retained earnings are restricted for a specific purpose, such as capital redemption, and therefore are not available for the payment of dividends.

From the perspective of U.S. financial reporting, the UK parent company balance sheet has an unusual structure. Rather than the U.S. norm of Assets = Liabilities + Shareholders' equity, Vodafone's parent company balance sheet is presented as Assets − Liabilities = Shareholders' equity. Closer inspection shows that the balance sheet presents the left-hand side of the equation as Noncurrent assets + Net current assets (or Working capital) − Noncurrent liabilities, which is equal to total Shareholders' equity.

All of these superficial differences would probably cause a U.S. financial analyst little problem in analyzing the British company's financial statements. More important than the format and terminology differences are the possible differences in recognition and measurement rules employed to account for assets and liabilities and to determine net income.

As was noted in the introduction to this chapter, very different amounts of net income and stockholders' equity can be reported by a company depending on the accounting rules that it uses. For example, the following chart summarizes results reported by the Colombian petroleum company, Ecopetrol S.A., in its 2014 Form 20-F annual report filed with the U.S. SEC:

(in millions of Colombian pesos)	**Colombian GAAP**	**U.S. GAAP**	**Percentage Difference**
Net income (A)	7,510,270	6,819,550	+10.1%
Average shareholders' equity (B)	69,832,587	44,705,918	+56.2%
Return on equity (A ÷ B)	10.8%	15.3%	−29.5%

Ecopetrol reported 10.1 percent more income and 56.2 percent more equity under Colombian GAAP than under U.S. GAAP.[4] As a result, return on equity calculated from the company's Colombian GAAP results was 29.5 percent smaller than if calculated from the U.S. GAAP amounts. The company disclosed 27 differences between Colombian GAAP and U.S. GAAP that affected the calculation of net income. The single most important difference related to the accounting for changes in foreign currency exchange rates. Financial statement analysts could come to a very different assessment of Ecopetrol's profitability depending on whether they based their analysis on Colombian GAAP or U.S. GAAP information.

REASONS FOR ACCOUNTING DIVERSITY

Why do financial reporting practices differ across countries? Accounting scholars have hypothesized numerous influences on a country's accounting system, including factors as varied as the nature of the political system, the stage of economic development, and the state of accounting education and research. A survey of the relevant literature identified the following five items as being commonly accepted as factors influencing the development of a country's financial reporting practices: (1) legal system, (2) taxation, (3) providers of financing, (4) inflation, and (5) political and economic ties.[5] In addition to economic and institutional determinants, national culture has long been considered a factor that affects the accounting system of a country.[6]

Legal System

There are two major types of legal systems used around the world: common law and codified Roman law. Common law began in England and is primarily found in the English-speaking countries of the world. Common law countries rely on a limited amount of statute law, which is then interpreted by the courts. Court decisions establish precedents, thereby developing case law that supplements the statutes. A system of code law, followed in most non-English-speaking countries, originated in the Roman *jus civile* and was developed further in European universities during the Middle Ages. Code law countries tend to have relatively more statute or codified law governing a wider range of human activity.

[4] Ecopetrol switched to IFRS in 2015 and no longer reports on a Colombian GAAP or U.S. GAAP basis in its Form 20-F.

[5] Gary K. Meek and Sharokh M. Saudagaran, "A Survey of Research on Financial Reporting in a Transnational Context," *Journal of Accounting Literature,* 1990, pp. 145–82.

[6] One of the first to argue that accounting is determined by culture was W. J. Violet in "The Development of International Accounting Standards: An Anthropological Perspective," *International Journal of Accounting,* 1983, pp. 1–12.

What does a country's legal system have to do with accounting? Code law countries generally have corporation law (sometimes called a commercial code or companies act) that establishes the basic legal parameters governing business enterprises. The corporation law often stipulates which financial statements must be published in accordance with a prescribed format. Additional accounting measurement and disclosure rules are included in an accounting law debated and passed by the national legislature. In countries where accounting rules are legislated, the accounting profession tends to have little influence on the development of accounting standards. In countries with a tradition of common law, although a corporation law laying the basic framework for accounting might exist (such as in the United Kingdom), specific accounting rules are established by the profession or by an independent nongovernmental body representing a variety of constituencies. Thus, the type of legal system in a country tends to determine whether the primary source of accounting rules is the government or a nongovernmental organization.

In *code law* countries, the accounting law tends to be rather general, does not provide much detail regarding specific accounting practices, and may provide no guidance at all in certain areas. Germany is a good example of this type of country. The German accounting law passed in 1985 is only 47 pages long and is silent with regard to issues such as leases, foreign currency translation, and cash flow statements.[7] When no guidance is provided in the law, German companies refer to other sources, including tax law, opinions of the German auditing profession, and standards issued by the German Accounting Standards Committee, to decide how to do their accounting. Interestingly enough, important sources of accounting practice in Germany have been textbooks and commentaries written by accounting academicians.

In *common law* countries, where there is likely to be a nonlegislative organization developing accounting standards, much more detailed rules are developed. The extreme case might be the Financial Accounting Standards Board (FASB) in the United States, which provides a substantial amount of implementation guidance in its accounting standards codification (ASC) and updates and has been accused of producing a "standards overload."

To illustrate this point, consider the rules related to accounting for leases established by the FASB in the United States and in German accounting law. In the United States, a lease must be classified and accounted for as a finance lease or an operating lease. Additional guidance establishes rules for specific situations such as sales with leasebacks and leveraged leases. In contrast, the German accounting law is silent with regard to leases. The only guidance in the law can be found in paragraph 285, which simply states that all liabilities must be recorded.[8]

Taxation

In some countries, published financial statements form the basis for taxation, whereas in other countries, financial statements are adjusted for tax purposes and submitted to the government separately from the reports sent to stockholders. Continuing to focus on Germany, prior to 2009, the principle of reverse conformity (*umgekehrte Massgeblichkeit*) in that country required that, in most cases, an expense deductible for tax purposes must also be used in the calculation of financial statement income. Well-managed German companies attempted to minimize income for tax purposes, for example, through the use of accelerated depreciation, so as to reduce their tax liability. As a result of the reverse conformity

[7] Jermyn Paul Brooks and Dietz Mertin, *Neues Deutsches Bilanzrecht* (Düsseldorf: IDW-Verlag, 1986).

[8] In compliance with EU regulations, Germany requires publicly traded companies to use IFRS to prepare their consolidated financial statements. German accounting law continues to be used by privately held companies and by publicly traded companies in preparing parent company financial statements.

principle, accelerated depreciation also had to be recognized in the calculation of accounting income. In 2009, the accounting modernization law (*Bilanzrechtsmodernisierungsgesetz*) removed the reverse conformity requirement, which has reduced the influence that taxation has on financial reporting in Germany.

In contrast, general conformity between the tax statement and the financial statements has never been required in the United States.[9] U.S. companies are allowed to use accelerated depreciation for tax purposes and straight-line depreciation in the financial statements. All else being equal, until 2009, because of the influence of the reverse conformity principle, a German company was likely to report lower accounting net income than its U.S. counterpart.

Providers of Financing

The major providers of financing for business enterprises are family members, banks, governments, and shareholders. In those countries in which company financing is dominated by families, banks, or the state, there will be less pressure for public accountability and information disclosure. Banks and the state will often be represented on the board of directors and will therefore be able to obtain information necessary for decision making from inside the company. As companies become more dependent on financing from the general populace through the public offering of shares of stock, however, the demand for more information made available outside the company becomes greater. It simply is not feasible for the company to allow the hundreds, thousands, or hundreds of thousands of shareholders access to internal accounting records. The information needs of those financial statement users can be satisfied only through extensive disclosures in accounting reports.

There can also be a difference in financial statement orientation, with stockholders being more interested in profit (emphasis on the income statement) and banks more interested in solvency and liquidity (emphasis on the balance sheet). Bankers tend to prefer companies to practice rather conservative accounting with regard to assets and liabilities.

Inflation

Historically, countries experiencing chronic high rates of inflation have found it necessary to adopt accounting rules that require the inflation adjustment of historical cost amounts. This has been especially true in Latin America, which as a region has had more inflation than any other part of the world. For example, throughout the 1980s and 1990s, the average annual rate of inflation rate in Mexico was approximately 50 percent, with a high of 159 percent in 1987.[10] Double- and triple-digit inflation rates render historical costs meaningless. Throughout most of the latter half of the 20th century, this factor primarily distinguished Latin America from the rest of the world with regard to accounting.[11] However, inflation has been successfully brought under control in most countries, and this factor is no longer as important in explaining accounting diversity as it once was.

Adjusting accounting records for inflation results in a write-up of nonmonetary assets (inventory, intangibles, and property, plant, and equipment), with a corresponding increase in expenses related to those assets (cost-of-goods-sold, amortization, and depreciation expenses). Adjusting income for inflation was especially important in those countries in which accounting statements served as the basis for taxation; otherwise, companies would have paid taxes on fictitious profits.

[9] An exception is the so-called “LIFO conformity rule,“ which stipulates that if the last-in-first-out (LIFO) cost flow method is used to determine taxable income, it must also be used in the financial statements.

[10] Joseph B. Lipscomb and Harold Hunt, “Mexican Mortgages: Structure and Default Incentives, Historical Simulation 1982–1998,” *Journal of Housing Research* 10, no. 2 (1999), pp. 235–65.

[11] Mexico continued its use of inflation accounting until 2007.

Political and Economic Ties

Accounting is a technology that can be relatively easily borrowed from or imposed on another country. Through political and economic links, accounting rules have been conveyed from one country to another. For example, through previous colonialism, both England and France have transferred their accounting frameworks to a variety of countries around the world. British-style accounting systems can be found in countries as far-flung as Australia and Zimbabwe. French accounting is prevalent in the former French colonies of western Africa. Perhaps the most striking example of political and economic ties influencing accounting across countries is the adoption of IFRS for publicly traded companies in the 27 countries comprising the European Union.

Correlation of Factors

Whether by coincidence or not, there is a relatively high degree of correlation between legal system, tax conformity, and source of financing. As Exhibit 2.4 shows, common law countries tend to have greater numbers of domestic listed companies per capita than code law countries. This indicates a greater usage of equity as a source of financing in common law countries. Code law countries tend to link taxation to accounting statements, whereas common law countries do not.

National Culture

Using responses to an attitude survey of IBM employees worldwide, Hofstede identified four cultural dimensions that can be used to describe general similarities and differences in cultures around the world: (1) individualism, (2) power distance, (3) uncertainty avoidance, and (4) masculinity.[12] More recently, a fifth cultural dimension, long-term orientation, was identified. *Individualism* refers to a preference for a loosely knit social fabric rather than a tightly knit social fabric (collectivism). *Power distance* refers to the extent to which hierarchy and unequal power distribution in institutions and organizations are accepted. *Uncertainty avoidance* refers to the degree to which individuals feel uncomfortable with uncertainty and ambiguity. *Masculinity* refers to an emphasis on traditional masculine values of performance and achievement rather than feminine values of relationships, caring, and nurturing. *Long-term orientation* stands for the "fostering of virtues oriented towards future rewards, in particular perseverance and thrift."[13]

EXHIBIT 2.4
Relationship between Several Factors Influencing Accounting Diversity

Source: Number of domestic listed companies and country populations obtained from IndexMundi, www.indexmundi.com.

		Domestic Listed Companies		
Country	**Legal System**	**Number**	**Per Million of Population**	**Tax Conformity**
Germany	Code	555	6.9	Yes
France	Code	490	7.3	Yes
Japan	Code	3,504	27.7	Yes
United Kingdom	Common	1,858	45.6	No
Australia	Common	1,989	86.5	No
Canada	Common	3,799	107.3	No

[12] G. Hofstede, *Culture's Consequences: International Differences in Work-Related Values* (London: Sage, 1980).

[13] G. Hofstede, *Culture's Consequences: Comparing Values, Behaviors, Institutions, and Organizations across Nations,* 2nd ed. (Thousand Oaks, CA: Sage, 2001), p. 359.

Accounting Values

From a review of accounting literature and practice, Gray identified four widely recognized accounting values that can be used to define a country's accounting subculture: professionalism, uniformity, conservatism, and secrecy.[14] Gray describes these accounting values as follows:[15]

> *Professionalism versus Statutory Control*—a preference for the exercise of individual professional judgment and the maintenance of professional self-regulation as opposed to compliance with prescriptive legal requirements and statutory control.
>
> *Uniformity versus Flexibility*—a preference for the enforcement of uniform accounting practices between companies and for the consistent use of such practices over time as opposed to flexibility in accordance with the perceived circumstances of individual companies.
>
> *Conservatism versus Optimism*—a preference for a cautious approach to measurement so as to cope with the uncertainty of future events as opposed to a more optimistic, laissez-faire, risk-taking approach.
>
> *Secrecy versus Transparency*—a preference for confidentiality and the restriction of disclosure of information about the business only to those who are closely involved with its management and financing as opposed to a more transparent, open, and publicly accountable approach.

Gray argues that national cultural values affect accounting values, as shown in Exhibit 2.5.

The accounting values of conservatism and secrecy have the greatest relevance for the information content of a set of financial statements. The relationship between culture and each of these two accounting values is explained as follows:

> Conservatism can be linked perhaps most closely with the uncertainty-avoidance dimension and the short-term versus long-term orientations. A preference for more conservative measures of profits and assets is consistent with strong uncertainty avoidance following from a concern with security and a perceived need to adopt a cautious approach to cope with uncertainty of future events. A less conservative approach to measurement is also consistent with a short-term orientation where quick results are expected and hence a more optimistic approach is adopted relative to conserving resources and investing for long-term trends. There also seems to be a link, if less strong, between high levels of individualism and masculinity, on the one hand, and weak uncertainty avoidance on the other, to the

EXHIBIT 2.5
Relationships between Accounting Values and Cultural Dimensions

Source: Lee H. Radebaugh and Sidney J. Gray, *International Accounting and Multinational Enterprises,* 5th ed. (New York: Wiley, 2001), p. 49.

	Accounting Values			
Cultural Dimension	**Professionalism**	**Uniformity**	**Conservatism**	**Secrecy**
Power distance	Neg.	Pos.	n/a	Pos.
Uncertainty avoidance	Neg.	Pos.	Pos.	Pos.
Individualism	Pos.	Neg.	Neg.	Neg.
Masculinity	Pos.	n/a	Neg.	Neg.
Long-term orientation	Neg.	n/a	Pos.	Pos.

Pos. = Positive relationship hypothesized between cultural dimension and accounting value.
Neg. = Negative relationship hypothesized between cultural dimension and accounting value.
n/a = No relationship hypothesized.

[14] S. J. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally," *Abacus,* March 1988, pp. 1–15.

[15] S. J. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally," *Abacus,* March 1988, p. 8.

extent that an emphasis on individual achievement and performance is likely to foster a less conservative approach to measurement.[16]

A preference for secrecy is consistent with strong uncertainty avoidance following from a need to restrict information disclosures so as to avoid conflict and competition and to preserve security. . . . [H]igh power-distance societies are likely to be characterized by the restriction of information to preserve power inequalities. Secrecy is also consistent with a preference for collectivism, as opposed to individualism, in that its concern is for the interests of those closely involved with the firm rather than external parties. A long-term orientation also suggests a preference for secrecy that is consistent with the need to conserve resources within the firm and ensure that funds are available for investment relative to the demands of shareholders and employees for higher payments. A significant but possibly less important link with masculinity also seems likely to the extent that in societies where there is more emphasis on achievement and material success there will be a greater tendency to publicize such achievements and material success.[17]

Gray's Cultural Accounting Framework

Gray extended Hofstede's model of cultural patterns to develop a framework that identifies the mechanism through which culture influences the development of corporate financial reporting systems on a national level. According to this framework (shown in Exhibit 2.6), the particular way in which a country's accounting system develops is influenced by accountants' accounting values and the country's institutional framework, both of which are influenced by cultural values. Thus, culture is viewed as affecting accounting systems indirectly in two ways: through its influence on accounting values and through its institutional consequences.

Using measures of each of the cultural values for a group of 40 countries, Hofstede classified countries into 10 different cultural areas. The Anglo cultural area, for example, is characterized by high individualism, low uncertainty avoidance, low power distance, and moderate masculinity. Given this pattern of cultural values, Gray hypothesized that Anglo countries (which include Australia, Canada, New Zealand, the United States, and the United Kingdom) would rank relatively low on the accounting values of conservatism and secrecy (or high on optimism and high on transparency). Exhibiting the opposite pattern of cultural values, the countries of the less developed Latin cultural area (which includes countries like Colombia and Mexico) would rank relatively high in conservatism and secrecy. On a scale of 1 (low secrecy) to 7 (high secrecy) and a scale of 1 (low conservatism) to 5 (high conservatism), the different cultural areas were ranked as follows:

Cultural Area	Secrecy	Conservatism
Anglo	1	1
Nordic	2	2
Asian-Colonial	2	3
African	3	4
More developed Latin	3	5
Less developed Asian	4	4
Japan	5	5
Near Eastern	5	5
Germanic	6	4
Less developed Latin	7	5

[16] Lee H. Radebaugh and Sidney J. Gray, *International Accounting and Multinational Enterprises,* 5th ed. (New York: Wiley, 2001), p. 47.

[17] Lee H. Radebaugh and Sidney J. Gray, *International Accounting and Multinational Enterprises,* 5th ed. (New York: Wiley, 2001), p. 48.