

CHAPTER ONE

INTERNATIONAL ACCOUNTING AND INTERNATIONAL BUSINESS

Chapter Objectives

- Identify the key trends in the development of accounting through history
- Highlight the evolution of business to modern times
- Identify the key environmental influences on business and accounting
- Discuss the major factors influencing the development of accounting and information disclosure in the global economy
- Discuss the important accounting dimensions of global business and the major topics that comprise the field of international accounting
- Introduce the chapters in the book

INTRODUCTION

What an exciting time to study international accounting as we enter the new millennium! We are closer than ever to having a uniform set of international accounting standards that firms can use as they list on stock exchanges all over the world. International business activity is increasing dramatically through traditional exporting and importing of goods and services as well as foreign direct investment. Capital markets are opening up and becoming more transparent, and capital flows freely around the world at a quicker pace. Stock markets are linking up with each other just as firms are increasing their global competitiveness, and accounting will be one of the key areas that will help determine how successful cross-border stock market linkages become. Companies are finding that they need to move quickly outside of their home country capital market if they want to be a truly multinational

Strategic Decision Point

DaimlerChrysler is one of the world's leading automotive companies, with passenger car brands that include Mercedes-Benz, Chrysler, Jeep®, and Dodge. It was formed in 1998 by the merger of the German company, Daimler-Benz AG and the American company, Chrysler Corporation. DaimlerChrysler has manufacturing, assembly, and sale operations worldwide and a global workforce of 387,000 employees. In addition to sales and manufacturing operations worldwide, DaimlerChrysler has a global shareholder base, issuing shares not only in its headquarters country, Germany, but also the United States, France, Switzerland, and Japan. DaimlerChrysler is affected by global events. As noted in its Q1 2005 Interim Report, "DaimlerChrysler assumes that the global economy will continue its present development in the coming months, thus expanding in line with its long-term growth trend. However, if raw-material prices, particularly for oil, remain at the current high levels for a longer period or rise even further, global economic development is expected to be negatively affected. Rising interest rates could also have a negative effect on consumer spending. For the further course of the year, the growth of worldwide demand for automobiles is likely to be slower than in 2004. Whereas further expansion of truck markets is expected in the NAFTA region, there are indications of decreasing market expansion in Europe. In general, we expect the highly competitive situation across the entire automotive industry to continue, due to further reductions in product lifecycles and ongoing over-capacity." DaimlerChrysler is a good example of a global company that must deal with all of the complexities of different national environments as well as global trends and provide a return to shareholders worldwide.

corporation, and the U.S. stock market has emerged as the location for new issues of foreign corporations. A new currency, the euro, was introduced in Europe in 1999, changing forever the notion of foreign exchange risk in Europe and changing the way European companies keep their accounts. And now the euro is even turning out to be a competitor for the U.S. dollar in global currency markets. To embark on our journey into the new millennium of international accounting, we will first trace the international development of accounting, highlight some of the critical factors that determine national differences in accounting systems, provide an initial perspective on these differences and their importance for accountants in the modern world, and outline the focus of the book. In addition, we will examine some of the key elements of international business and how they affect company strategy and the accounting function within that strategy.

THE INTERNATIONAL DEVELOPMENT OF THE ACCOUNTING DISCIPLINE

Many books have been written on the origin of accounting, but no one has been able to establish when it really began. Clearly, accounting is a function of the busi-

ness environment in which it operates, and it originated in order to record business transactions. The origin of accounting and its subsequent changes are therefore best studied in the context of the history of commercial transactions. Although the recording of transactions is probably as old as the history of record keeping, we tend to think of the establishment of double-entry accounting, the basis for modern accounting, as the key event. In 1994, the seventeenth annual congress of the European Accounting Association (EAA) was held in Venice to celebrate the 500-year anniversary of the publication of the first printed book on double-entry accounting by Luca Pacioli. Why were the Italians so influential in the development of double-entry accounting, and could it have developed elsewhere?

Early Italian Influence

Record keeping, the foundation of accounting, has been traced back as far as 3600 B.C., and historians know that mathematical concepts were understood in various ancient civilizations from China, India, and Mesopotamia—often referred to as the “Cradle of Civilization”—to some of the ancient native cultures of Central and South America. Business transactions in different areas around the world, including the city-states of central and northern Europe, probably gave rise to the recording of business transactions.

Double-entry accounting was probably developed in the Italian city-states between the thirteenth and fifteenth centuries. The most significant influences on accounting took place in Genoa, Florence, and Venice. There is no defining moment when double-entry accounting was born, but it seems to have evolved independently in different places, responding to the changing nature of business transactions and the need to record them properly. The Genoese system was probably a development of the ancient Roman system. Commercial activity had been flourishing in Genoa for a long time, and Genoa was at the height of its wealth and power during the fourteenth century. The Genoese system assumed the concept of a business entity. Because it recorded items in terms of money, it was the first to imply that dissimilar items could be compared in terms of a common monetary unit. The system also implied some understanding of the distinction between capital and income in that it included both expenses and equity accounts. The oldest double-entry books were the Massari (treasury officials) ledgers of the Commune of Genoa, dating from 1340. Given that they were written in perfect double-entry form, it stands to reason that the concepts must have originated and evolved earlier than that. In fact, the government of the Commune of Genoa decreed in 1327 that government accounts had to be kept in the same way that the banks kept their accounts. It would therefore seem natural that double-entry accounting existed with Genoese banks prior to 1327, even though we have no records of Genoese banks prior to 1408.

Florentine commerce also flourished in the thirteenth and fourteenth centuries, giving rise to double-entry accounting there as well. In 1252, Florence coined the gold florin, which was soon accepted as the standard gold piece all over Europe. A major achievement in Florence was the development of large associations and compagnie (partnerships) that pooled capital, initially within family groups and then from outside the family groups. Given the nature of Florence as an artistic center, it is easier to find manuscripts relating to the development of bookkeeping. The

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account books of the fourteenth century reflect the partnership contracts of the *compagnie*, which identified the capital of the separate partners, made provisions for the division of profits and losses, clearly defined the duties of each partner, and provided for the dissolution of the *compagnie*. Records were often kept in great detail, almost in narrative form. Until the influence of the Venetians, Florentine accounts listed debits above credits rather than on separate pages. Separate columns for transactions were needed to record which monetary value was used.

However, Venice was key in the spread of double-entry accounting. Venice was the key commercial city of the Renaissance because of its commercial empire and advantages as a port. The Venetians may not have developed double-entry accounting before the Genoese and Florentines, but Venice “developed it, perfected it, and made it her own, and it was under the name of the Venetian method that it became known the world over” (Peragallo, 1938).

Luca Pacioli

Luca Pacioli, who was born in San Sepolcro in the Tuscany region of Italy in 1447, was not an accountant but was educated as a mathematician by Franciscans and actually became a Franciscan monk himself. In 1464, he became the tutor of the three sons of a Venetian merchant, then left Venice to study mathematics. After becoming a Franciscan monk, he accepted a teaching position at the University of Perugia, then traveled extensively and taught at the universities of Florence, Rome, Naples, Padua, and Bologna. In 1494, in Venice, he published the first significant work on accounting up to that point, *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*, more commonly known as *Summa de Arithmetica*. His discussion of accounting comprises one of the chapters in the *Summa de Arithmetica*. Given the extreme detail included in the book and the fact that Pacioli was not a merchant or bookkeeper, many historians believe he got his information from somewhere else. In fact, Pacioli did not claim that his ideas were original, just that he was the one who was trying to organize and publish them. His objective was to publish a popular book that everyone could use, following the influence of the Venetian businessmen rather than the bankers. Wherever his ideas originated, the Venetian method became the standard for not only the Italians but also the Dutch, German, and English authors on accounting.

Pacioli introduced three important books of record: the memorandum book, the journal, and the ledger. The memorandum book included all information on a transaction. From the memorandum book, a journal entry was made into the journal. Information was then posted to the ledger, the center of the accounting system. Pacioli felt that all transactions required both a debit and credit in order for the transaction to remain in equilibrium.

Subsequent Developments

The growing literature on accounting represented an attempt to describe good practices rather than challenge underlying assumptions or develop a general theory of accounting. The literature began to change during the 1550s to reflect new commercial and political realities. The rise of nation-states and the need to manage

public finances increased the importance of good accounting practice. However, a major change was the decline of Italy as a world commercial power. As commercial traffic shifted from the ports of Venice to the Atlantic shipping routes, Italy slipped in importance, and relatively few new developments took place in accounting. It is true that changing business forms that emphasized large-scale business enterprises caused a change in focus, but accounting authors still clung to the old forms of accounting, and no new theories developed.

The French Revolution in the late 1700s marked the beginning of a great social upheaval that affected governments, finances, laws, and customs. Italy came under the influence of the French and then the Austrians, and their system of double-entry accounting was also influenced. It is interesting to note that Napoleon was surprised at how efficient the Italian system of accounting was. The serious study of accounting and development of accounting theory also began in this period and has continued to the present day. However, the influence of the Arabs, Genoese, Florentines, and Venetians continues to be felt in the double-entry system we use today. Even the British, who acquired their knowledge of double-entry accounting soon after Pacioli's *Summa de Arithmetica* was published, did not begin adopting double-entry accounting quickly until the Industrial Revolution of the period 1760–1830. At that point, the importance of accounting grew substantially.

As the scale of enterprises increased following technological breakthroughs such as mass production, and as fixed assets grew in importance, it became necessary to account for depreciation, the allocation of overhead, and inventory. In addition, the basic form of business organization shifted from proprietorships and partnerships to limited liability and stock companies and ultimately to stock exchange listed corporations. Accounting had to adapt to satisfy these new needs. Increased government regulation of business made new demands on firms, which also generated new accounting systems. Most notable was the increased taxation of business and individuals, which brought with it new tax accounting systems and procedures.

Since the early 1900s, the rapidity of change and the increasing complexity of the world's industrial economies necessitated still more changes in accounting. Mergers, acquisitions, and the growth of multinational corporations fostered new internal and external reporting and control systems. With widespread ownership of modern corporations came new audit and reporting procedures, and new agencies became involved in promulgating accounting standards: namely, stock exchanges, securities regulation commissions, internal revenue agencies, and so on. Finally, with the dramatic increase in foreign investment and world trade and the formation of regional economic groups such as the European Union, problems arose concerning the international activities of business. This phenomenon remains particularly complex, for it involves reconciling the accounting practices of different nations in which each multinational operates, as well as dealing with accounting problems unique to international business.

NATIONAL DIFFERENCES IN ACCOUNTING SYSTEMS

One might infer that these historical developments had a uniform effect on accounting systems throughout the world, yet nothing could be further from the truth. Despite some similarities, there are at least as many accounting systems as

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there are countries, and no two systems are exactly alike. The underlying reasons for these differences are essentially environmental: accounting systems evolve from and reflect the environments they serve, just as in Genoa, Florence, and Venice in the 1400s. The reality of the world is that environments have not evolved uniformly or simultaneously. Countries today are at stages of economic development ranging from subsistence, barter economies to highly complex industrial societies.

While accounting practices were evolving, there were, for example, differences in the amount of private ownership, the degree of industrialization, the rate of inflation, and the level of economic growth. Given these differences in economic conditions, differences in accounting practices should not be surprising. Just as the accounting needs of a small proprietorship are different from those of a multinational corporation, so are the accounting needs of an underdeveloped, agrarian country different from those of a highly developed industrial country. Economic factors, however, are not the only influences. Educational systems, legal systems, political systems, and sociocultural characteristics also influence the need for accounting and the direction and speed of its development.

At the present time, the most important reason for understanding different national accounting systems lies in the increasing globalization of business. Before examining in greater detail the environmental influences on accounting and the unique accounting problems of multinational enterprises, let's take a brief look at the evolution and significance of international business.

THE EVOLUTION AND SIGNIFICANCE OF INTERNATIONAL BUSINESS

International business can be traced back to several centuries B.C. As far as anyone can tell, the reasons and motives were the same then as they are today: people wanted something they did not have in their own country, and they found someone in another country able to provide them with what they wanted. But trade on a major and planned scale did not really begin until the Greeks started exporting inexpensive, mass-produced goods around the fifth century B.C. By the end of the Greek period, there was sufficient trade to have permitted not only full-time professional traders but even some traders who specialized by area of the world or by commodities.

During the Roman period, traders roamed freely through the empire, and with better transportation, political stability, and few tariffs and trade restrictions, trade flourished. In fact, the Roman Empire established the feasibility and desirability of what is now known as the European Union.

During the Middle Ages, international business flourished in some areas of the world. For example, it flourished in Byzantium (present-day Istanbul) until the Crusades, facilitated by the development of banking and insurance and by the first large-scale international trade fairs. However, international trade did not fare as well in Europe until much later. Wars, plagues, and a generally anticommercial religious doctrine hindered commerce both domestically and internationally. It was not until the twelfth century that commercial activity and trade broke out of their undeveloped state. With their resurgence came laws and regulations regarding commerce and trade. Initially developed by guilds, then by city-states, and then

much later by nation-states, international commercial regulations have continued to proliferate to the present day.

The Preindustrial Period

As Europe emerged from the Dark Ages, merchants sought ways to increase international business. By that time, however, the right to trade had become a privilege granted by the state, a phenomenon that has persisted to modern times. The privilege was based on what was to be known as mercantilism, a concept by which each state sought to become more pervasive and powerful militarily, economically, and politically than its rivals. During this period of mercantilism, the state was the driving and controlling force behind domestic and international economic activity.

The sixteenth and seventeenth centuries saw the first major foreign investments, under the rubric of colonialism. Governments invested directly in colonies, or gave individuals the right to do so, with the express purpose of obtaining raw materials first, then products, in a near-monopolistic control of trade. Finally, during this period of mercantilism the center of commercial and financial activity shifted steadily westward, from Byzantium to Italy, to the Netherlands and Belgium, and ultimately to Britain. This dominating influence of Western Europe was to last until the twentieth century.

The Industrialization Period

The Industrial Revolution, which began in the latter half of the eighteenth century, continued to have a major impact on international business throughout the nineteenth and twentieth centuries. The Industrial Revolution and its accompanying technologies gave rise to mass production and standardization of products and required sizable capital investments on an unparalleled scale. The emergence of large-scale, limited-liability companies combined with large-scale infrastructure projects such as railroads, canals, and power-generating systems often necessitated obtaining capital from other countries—a major form of international business that has continued to the present. To exploit scale economies of production fully, the exporting of mass-produced goods became a necessity for many firms located in countries with small domestic markets. Simultaneously, industrialization often required an increase in the importation of raw materials and capital goods in many countries that did not possess them in sufficient quantity or quality. The multinational firm as it is known today emerged in this period, with early overseas expansion by firms such as Singer, Ford, Dunlop, and Lever Brothers.

The industrialization process also brought with it growing trade restrictions as many nations sought to protect their “infant industries.” Although there was relatively little U.S. government interference or involvement with international trade or investment during this period, there was growing foreign government involvement, particularly in trade. This prompted many firms to begin replacing exports with direct investments in the more protectionist countries in order to keep their established markets. Despite the continued increase in both trade and investments, a trend was established: foreign investments were becoming much more influential.

The Post–World War II Period

The Great Depression and World War II stunted the growth of international business. The reasons are fairly obvious: drastic reductions in income; the bankruptcy of individuals, companies, and governments; then war, the destruction of property, and an end to the stability of money. Throughout this period, trade protectionism and the regulation of capital flows were on the rise, which, when combined with the other factors just mentioned, slowed the growth of international business activity.

At the end of World War II, there was a tremendous pent-up demand for products and services. With some semblance of order restored to international politics and the international monetary system, both trade and investment increased sharply.

The remnants of 1930s and early 1940s protectionism conspired to emphasize investment. The formation of the European Economic Community in the late 1950s (now the European Union), with its strong economy and the elimination of its internal trade restrictions, resulted in significant growth of U.S. manufacturing investment abroad. During the 1970s and 1980s, this trend had slowed considerably, but it was followed by an equally significant increase of foreign investment in the United States. However, the move to a more unified European Union resulted in significant interest in Europe once again.

The Multinational Era

The proliferation of multinational enterprises and their activities has constituted perhaps the most significant development in international business. Their wealth and influence are significant, yet the impressive role that they now play is far from the whole story of the growth in international business. For virtually all of the world's economies, international trade and foreign investment have increased in importance as a percentage of total economic activity.

Reasons for International Involvement

International business includes all business transactions that involve two or more countries. These transactions can be conducted exclusively in the private sector, or they can also involve the public sector. Companies get involved in international business for a variety of reasons. The major reason is to expand sales, perhaps because a firm has excess capacity and does not have additional sales opportunities at home. Thus, it needs to sell products abroad to utilize its capacity more efficiently. International sales can also be profitable.

A second reason to get involved in international business is to gain access to raw materials or other factors of production. Mining and agricultural companies operate in countries where natural resources or climate allow them to pursue their activities. On the other hand, manufacturing companies have found many developing countries in Eastern Europe, Asia, and Latin America to be ideal for doing business because of cheap labor and overhead-type expenses. Thus, they have expanded abroad to gain production efficiencies.

A third incentive for international activity is to gain access to knowledge. Learning about new technology quickly can make a big difference in a company's ability to compete in global markets. New technology is being developed worldwide, so companies cannot rely on their domestic market to keep abreast of new developments.

FORMS OF INTERNATIONAL INVOLVEMENT

When companies, and especially the market seekers, first begin to expand beyond domestic markets, they usually get involved in exports and imports. Merchandise exports are goods sent out of a country, and merchandise imports are goods brought into a country. Exports and imports can also involve services as well as goods. Service exports refer to the receipt of earnings from the performance of services abroad. For example, if KPMG sent auditors to different countries to perform an audit and received a fee for those services, that work would be considered a service export. The country where the work was performed would experience a service import, which would result in an outflow of cash to the exporting country. Other examples of services are travel, tourism, and transportation.

In addition to exporting and importing, companies can expand abroad through one of several types of strategic alliances. A strategic alliance is used to describe a wide variety of collaborations, which are of strategic importance to one or more of the parties involved. Strategic alliances include licensing agreements, franchising, management contracts, custom contracts, and shared ownership of foreign companies. The choice of the type of strategic alliance depends on legal factors, cost, experience, competition, risk, control, and product complexity.

Two similar strategic alliances involve a licensing agreement and a franchise agreement. A licensing agreement exists when one company grants rights to intangible property to another company for a specified period of time in return for a royalty. The intangible property might involve a production process, formula, design, pattern, patent, or invention. Companies enter into licensing agreements to earn a return on their intellectual property without having to undertake the risk of expanding abroad using their own capital. A franchise, such as those of Holiday Inn or McDonald's, involves the use of a trademark that is an essential asset but also provision of assistance on a continual basis in running the business. Holiday Inn, for example, provides a reservation service for franchisees and continual audits on quality, and so on. Sometimes companies will cooperate in the development of new technology or in producing goods and services.

Companies can also invest abroad. A direct investment occurs when a company assumes some degree of control over a foreign corporation in order to influence management decisions. The decision can occur in the form of an acquisition of existing stock in a local firm or in the establishment of a "greenfield investment," which is the establishment of a new firm in a foreign location. If the investor owns 100 percent of the stock in the local firm, that firm becomes a wholly owned subsidiary. If two or more firms are involved in establishing a venture, the operation is known as a joint venture, another form of strategic alliance. Joint ventures often occur because the investor lacks financial or managerial expertise or because the investor needs to rely on the local knowledge of the partner in the venture.

Multinational Enterprises

A variety of terms describe companies involved in international business. The most frequently used term is multinational enterprise (MNE), which refers to companies that have a worldwide view of production, the sourcing of raw materials and components, and final markets. There is no consensus as to how much of a company's sales, assets, earnings, and employees must be abroad for the firm to be considered an MNE, but anything less than 10 percent of these indicators would probably disqualify a company from the elite group of MNEs. More than 10 percent implies that the companies are operating in at least two countries, and most MNEs have significant geographical spread. The lack of a global vision is another indicator that a company is not yet an MNE. Another indicator of multinational involvement is the degree of international experience of key executives. In Chapter 12, we will discuss how MNEs adopt different strategies to operate internationally, including transnational, global, and multidomestic strategies. However, we will continue to use the term *MNE* to refer to companies that are operating in many different countries, regardless of the specific strategic approach they use to sell products and source production.

Large MNEs

It is difficult to identify precisely the largest MNEs in the world because there are different definitions of size. The two most commonly used measures for size are market value and sales. In addition, other measures, such as profits and return on shareholders' equity, are often used to compare companies worldwide. Exhibit 1.1 identifies the top 50 companies in the world by market value and by sales. Although U.S. companies dominate the list, there are companies from other countries in the world. In the *Business Week* Global 1000 companies, 423 are from the United States. Japan has the second largest number of companies with 137, and Britain is third with 73 companies. There are companies from seven developing countries, primarily from Asia and Latin America, with India having the largest number of companies at 8, closely followed by China and Mexico with 6 companies each. It is interesting to note that Wal-Mart de Mexico is the third largest company in Mexico, while its parent, Wal-Mart Stores of the United States is the fifth largest company in the world in market value and #1 in sales. Gazprom of Russia is the 47th largest company in the world in market value, the highest-ranking company from a developing country. Most of the companies in the top 50 would also qualify as MNEs because of the importance of global markets to sales. It is interesting to note that the firms on the list are from a variety of industries. Even though the large MNEs are the ones most noticed and discussed, a company does not have to be large to be engaged in international business. The probability that a firm will engage in international transactions increases with firm size and as the firm begins to saturate the domestic environment. However, even small companies can export or import, manufacture products abroad or source production to independent manufacturers abroad, or get involved in licensing agreements. This is especially true of high-tech start-up companies that often get involved in international business immediately. In addition, some companies such as Nike design products in the domestic market but

Exhibit 1.1 Top 50 Companies by Market Value and Sales

Top 50 Companies by Market Value in 2004				
Rank		Name	Country	Market Value (\$ Billions)
2004	2003			
1	1	General Electric	U.S.	328.11
2	2	Microsoft	U.S.	284.43
3	3	Exxon Mobil	U.S.	283.61
4	4	Pfizer	U.S.	269.66
5	5	Wal-Mart Stores	U.S.	241.19
6	6	Citigroup	U.S.	239.43
7	9	BP	Britain	193.05
8	10	American International Group	U.S.	191.18
9	13	Intel	U.S.	184.66
10	8	Royal Dutch Petroleum	Netherlands	174.83
11	21	Bank of America	U.S.	169.84
12	7	Johnson & Johnson	U.S.	165.32
13	14	HSBC Holdings	Britain	163.09
14	12	Vodafone Group	Britain	159.15
15	18	Cisco Systems	U.S.	152.23
16	11	International Business Machines	U.S.	150.55
17	17	Procter & Gamble	U.S.	139.35
18	22	Berkshire Hathaway	U.S.	136.86
19	26	Toyota Motor	Japan	130.65
20	20	Coca-Cola	U.S.	125.56
21	19	Novartis	Switzerland	125.51
22	16	GlaxoSmithKline	Britain	124.05
23	24	Total	France	122.94
24	15	Merck	U.S.	105.21
25	31	Nestle	Switzerland	104.87
26	32	Wells Fargo	U.S.	99.85
27	28	Altria Group	U.S.	98.20
28	36	ChevronTexaco	U.S.	96.70
29	40	Roche Holding	Switzerland	95.93
30	25	Verizon Communications	U.S.	95.77
31	38	Royal Bank of ScotlandGroup	Britain	94.37
32	23	NTT DoCoMo	Japan	92.17
33	35	Pepsico	U.S.	91.28
34	33	Dell	U.S.	90.08
35	46	UBS	Switzerland	84.79
36	48	Eli Lilly	U.S.	83.21
37	50	ENI	Italy	82.07
38	37	Home Depot	U.S.	81.73
39	41	United Parcel Service	U.S.	80.69
40	60	Nippon Telegraph & Telephone	Japan	79.02
41	29	SBC Communications	U.S.	78.41
42	42	AstraZeneca	Britain	78.36
43	44	Time Warner	U.S.	77.64

(continues)

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Top 50 Companies by Market Value in 2004				
Rank		Name	Country	Market Value (\$ Billions)
2004	2003			
44	49	J.P. Morgan Chase	U.S.	75.25
45	58	Telefonica	Spain	72.08
46	NR	Samsung Electronics	Korea	71.07
47	NR	Gazprom	Russia	70.78
48	51	Deutsche Telekom	Germany	70.53
49	30	Amgem	U.S.	70.02
50	27	Nokia	Finland	66.95

Source: *Business Week* Global 1000

Top 10 Companies by Sales in 2004				
Rank		Name	Country	Sales (\$ Billions)
2004	2003			
1	1	Wal-Mart Stores	U.S.	263.00
2	5	BP	Britain	232.57
3	3	Exxon Mobil	U.S.	222.88
4	4	Royal/Dutch Shell Group	Britain/Neth.	201.73
5	2	General Motors	U.S.	195.32
6	6	Ford Motor	U.S.	164.51
7	7	DaimlerChrysler	Germany	156.60
8	8	Toyota Motor	Japan	153.11
9	9	General Electric	U.S.	134.18
10	14	Total	France	118.44
11	12	Allianz	Germany	114.95
12	15	ChevronTexaco	U.S.	112.94
13	31	Axa	France	111.91
14	36	ConocoPhillips	U.S.	99.47
15	20	Volkswagen	Germany	98.94
16	16	Nippon Telegraph & Telephone	Japan	98.23
17	17	ING Group	Netherlands	95.89
18	13	Citigroup	U.S.	94.71
19	19	International Business Machines	U.S.	89.13
20	25	American International Group	U.S.	81.30
21	21	Siemens	Germany	80.50
22	29	Carrefour	France	79.77
23	26	Hitachi	Japan	76.42
24	40	Hewlett-Packard	U.S.	73.06
25	28	Honda Motor	Japan	72.26
26	39	McKesson	U.S.	69.51
27	27	U.S. Postal Service	U.S.	68.53
28	24	Verizon Communications	U.S.	67.75
29	44	Assicurazioni Generali	Italy	66.75
30	32	Sony	Japan	66.37
31	34	Matsushita Electric Industrial	Japan	66.22

Top 10 Companies by Sales in 2004

Rank		Name	Country	Sales (\$ Billions)
2004	2003			
32	41	Nissan Motor	Japan	65.77
33	38	Nestle	Switzerland	65.41
34	37	Home Depot	U.S.	64.82
35	78	Berkshire Hathaway	U.S.	63.86
36	33	Nippon Life Insurance	Japan	63.84
37	35	Royal Ahold	Netherlands	63.46
38	55	Deutsche Telekom	Germany	63.20
39	52	Peugeot	France	61.38
40	30	Altria Group	U.S.	60.70
41	58	Metro	Germany	60.66
42	57	Aviva	Britain	59.72
43	63	Eni	Italy	59.30
44	59	Munich RE Group	Germany	59.08
45	48	Credit Suisse	Switzerland	58.96
46	NR	State Grid	China	58.35
47	89	HSBC Holdings	Britain	57.61
48	54	BNP Paribas	France	57.27
49	60	Vodafone	Britain	56.84
50	53	Cardinal Health	U.S.	56.83

Source: Fortune Global 500

manufacture all of their products offshore through independent manufacturers—in countries outside their home country.

The Decision to Become Global

The decision to become global depends on how effectively management assesses two different but interactive dimensions: the external environment and the internal capabilities of the firm.

Environmental Constraints Environmental constraints strongly influence the elements of the management process, which in turn affect management and managerial effectiveness, which determines firm efficiency (Farmer and Richman, 1965). Figure 1.1 identifies the major international and local constraints that affect the MNE. The environmental constraints are grouped into four categories: educational, sociological (or sociocultural), political and legal, and economic. The educational characteristics include the level of literacy, the availability of specialized and higher education, the attitude toward education, and the match of education with skill requirements in the economy. Sociocultural characteristics include the attitude toward managers and authority, interorganizational cooperation, attitude toward achievement and work, class structure and individual mobility, and attitudes toward wealth, rationality, risk taking, and change.

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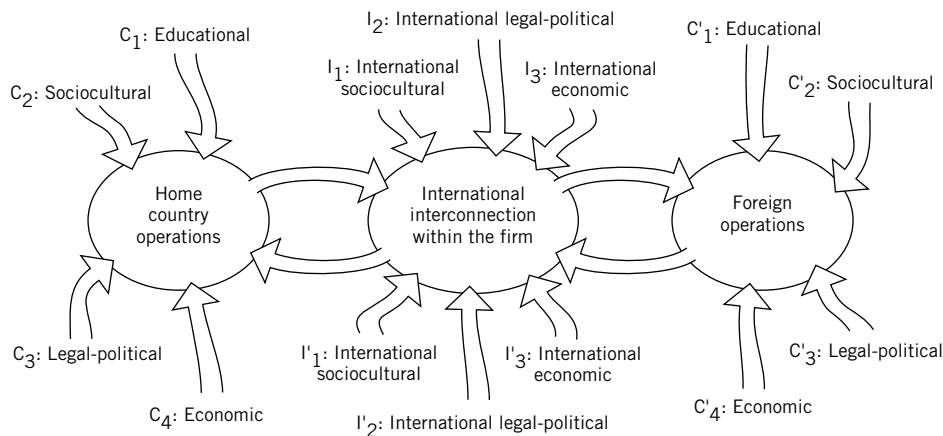


Figure 1.1 International and Local Constraints Affecting a Multinational Firm

Among the major political and legal characteristics are the relevant legal rules of the game and flexibility in their application, defense and foreign policy, political stability, and political organization. Key economic characteristics are the general economic framework, fiscal and monetary policy, economic stability, capital markets, factor endowments, and market size.

These constraints are labeled C1 (educational), C2 (sociocultural), C3 (legal-political), and C4 (economic). The basic idea behind Figure 1.1 is that management operating in the home country is influenced in its operating decisions by the environmental constraints in that country. Any company, domestic or foreign, needs to be aware of those constraints. When operations are set up in a foreign country, the constraints change. There are economic constraints in both the home and foreign country, but those constraints may be different.

As Figure 1.1 shows, there is also a list of international environmental constraints, and each country has its own unique set. Firms that cross national boundaries must adjust to the new set of environmental constraints in the host country. However, the mere crossing of boundaries introduces a different set of international environmental constraints. The sociological constraints (I1) include national ideology, the attitude toward foreigners, and the nature and extent of nationalism. The attitude toward investments by U.S. MNEs, for example, may be very different in the United Kingdom than it is in Iran. Important legal-political constraints (I2) are relevant legal rules for foreign business—such as import-export restrictions, foreign investment restrictions, profit remission restrictions, and exchange control restrictions. Economic constraints (I3) include the general balance-of-payments position, international trade patterns, and membership and obligations in international financial organizations.

Environmental constraints can rarely be changed by the MNE, so management has to decide whether or not those constraints would permit successful foreign investment. Sometimes management becomes overwhelmed with the differences and takes a polycentric attitude, which implies that all operating policies and procedures must be adjusted to the local environment. This is especially true of

MNEs from the Western Hemisphere investing in Asia. In other cases, management takes an ethnocentric attitude, which means that everything the MNE does in the home country can be transferred to the foreign country, in spite of the environmental differences. Although the MNE can act as an agent of change in many circumstances, the ethnocentric attitude is usually a little extreme.

An important dimension of the environmental constraints is that some countries might have country-specific advantages, also known as location-specific advantages, that might strongly influence foreign investment. For example, the existence of a key natural resource; the availability of a plentiful, cheap labor supply; or the presence of a large market are country-specific advantages and are reasons why an MNE might want to invest in a particular location. These country-specific advantages would exist as incentives, rather than barriers, to investment.

Firm-Specific Advantages The firm-specific advantages, also called ownership-specific advantages, relate primarily to the intangible assets that the firm possesses. In many cases, MNEs are basically in oligopolistic industries. However, smaller firms may have a firm-specific advantage because of a market niche or unique product capability. Typically, these firm-specific advantages are not easily duplicated by competitors, except in the long run or at very high costs. Thus, “The core skill of the MNE can be some element of its management structure, marketing techniques, or overall strategic planning that leads to a firm-specific advantage. These firm-specific advantages are modeled as endogenous to the MNEs, since their internal markets permit the MNEs to control them” (Rugman, Lecraw, and Booth, 1985).

A firm with a set of firm-specific advantages has a variety of options available for their productive use. As we mentioned earlier, the firm could exploit this advantage through exports. However, barriers to exports then lead the firm to explore other options. Selling the firm-specific advantage to another firm is a possibility, but the gains from the sale would not be as high as they would if the firm were to use the firm-specific advantage internally. A firm that decides to use the firm-specific advantages rather than sell them to other firms internalizes the firm-specific advantages.

ENVIRONMENTAL INFLUENCES ON ACCOUNTING

Now that we have examined the origins of accounting and international business, let's focus more specifically on factors in the domestic and international environment that influence accounting. To a large extent, corporate accounting and information disclosure practices are influenced by a variety of economic, social, and political factors. A model of the environmental influences is presented in Figure 1.2. These include the nature of enterprise ownership, the business activities of the enterprise, sources of finance and the stage of development of capital markets, the nature of the taxation system, the existence and significance of the accounting profession, the state of accounting education and research, the nature of the political system, the social climate, the stage of economic growth and development, the rate of inflation, the nature of the legal system, and the nature of accounting regulation. The nature of accounting systems at the country level will vary according to the relative influence of these environmental factors; such systems will, in turn, tend to reinforce established patterns of behavior.

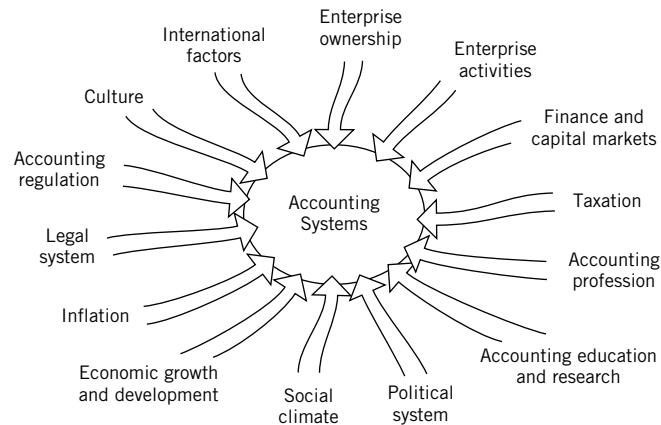


Figure 1.2 Environmental Influences on Accounting Development

With respect to **enterprise ownership**, the need for public accountability and disclosure will be greater where there is a broad ownership of shares compared to family ownership. Where there is state ownership, the influence of centralized control on accounting systems will tend to override the serving of microeconomic objectives. The activities of enterprises will also influence the nature of the accounting system depending on whether the business is agricultural, extractive, or manufacturing; whether it is diversified; whether it is multinational; and whether it is a large group of companies or a small business.

The **sources of finance** are another important influence. Clearly, there will be more pressure for public accountability and information disclosure when finance is raised from external shareholders via stock exchanges rather than banks or family sources, where information will be available more directly.

Taxation is a very important factor in situations where accounting systems are strongly influenced by state objectives; that is, in countries like France and Germany, public accounting reports are used as a basis for determining tax liabilities. In the United States and the United Kingdom, on the other hand, the published accounts are adjusted for tax purposes and submitted separately from the reports to shareholders.

Where there is a more developed **accounting profession** there are likely to be more developed, judgmentally based public accounting systems rather than more centralized and uniform systems. Furthermore, the development of professional accounting will depend on the existence of a sound infrastructure of **accounting education and research**, which is often lacking in developing countries.

The **political system** is obviously a very important influence on accounting in that the nature of the accounting system will reflect political philosophies and objectives (e.g., central planning versus private enterprise). The **social climate**, that is, attitudes toward informing and consulting employees and toward environmental concerns, will also be influential. In Europe, for example, there is a much more positive approach to the disclosure of information relating to such matters than in the United States.

The nature and extent of **economic growth and development** will also be influential insofar as a change from an agricultural to a manufacturing economy will pose new accounting problems, such as the depreciation of machinery, leasing, and so on. In many countries, services are now becoming more important, and thus problems related to how to account for intangible assets such as brand names, goodwill, and human resources have become significant. **Inflation** is often associated with economic growth and is a major influence on accounting where hyperinflation has been rife (e.g., in South America) to the extent that alternative systems to the traditional historical cost approach are often used.

The **legal system** is also important in determining the extent to which company law governs the **regulation of accounting**. In countries such as France and Germany, with a tradition of codified Roman law (or civil codes)—versus common law as in the United Kingdom and the United States—accounting regulations tend to be detailed and comprehensive. Furthermore, the accounting profession tends to have much less influence in setting accounting standards in such countries compared to countries such as the United Kingdom and the United States, where company law is supplemented by professional regulation.

In addition, the influence of **culture** (i.e., societal or national values) on accounting traditions and practices needs to be taken into account. **International factors** are also bringing about changes in the environment that are creating harmonization in international accounting in contrast to the constraining influences operating at national levels. One important international factor is colonial influence. Countries that are former colonies of the United Kingdom tend to use the British approach to accounting, whereas former French colonies tend to use the French system. In addition, membership in regional trade blocs, such as the European Union, often results in a convergence of accounting standards for countries within the bloc. Finally, the International Accounting Standards Board, an international organization dedicated to the convergence of accounting standards worldwide, is working hard to bridge the differences in accounting standards worldwide so that investors can make decisions based on common accounting standards and practices worldwide.

Naturally, the influence of these factors is dynamic and will vary both between and within countries over time. Moreover, an evolutionary process of some complexity appears to be at work that is reflected in a growing number of international and regional influences. These include the activities of MNEs and intergovernmental organizations such as the United Nations (UN), the Organization of Economic Cooperation and Development (OECD), and the European Union. In the European context, the European Union is an especially significant influence in that any agreement on the harmonization of accounting and information disclosure eventually becomes legally enforceable through a process of implementation in the national laws of the member countries.

Although there are many differences in national environments, with correspondingly varying effects on accounting systems, there are also many similarities. Attempts to classify countries and identify patterns or groupings are still very much in the early stages. However, such efforts appear to be a useful way to gain a better understanding of the key factors influencing the development of accounting systems and thus help us predict likely changes and their impact.

Accounting systems in socialist economies tend to be quite different from those in developed market economies such as the United States, Japan, and the EU

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countries. In the former socialist economies of Russia and Eastern Europe, for example, accounting is making a transition to a market approach. As far as public accounting and reporting in the market economies are concerned, however, a number of distinct models of accounting appear to be identifiable, including, at the very least, the British-American and continental European traditions. But given the factors of change at work, making accurate assessments or predictions about the future evolution of accounting is difficult. Because of the activities of many national and international organizations and the changing nature of business and especially multinational operations, accounting today is in a state of flux. It may well be that new models or patterns of accounting and reporting are being formed. The British and continental European traditions, for example, are now being coordinated and to some extent fused through EU efforts to harmonize accounting.

We will now discuss in greater detail some of the factors that have greatest influence on the development of accounting and information disclosure by corporations.

MAJOR DEVELOPMENT FACTORS**Corporations as Legal Entities**

The emergence of corporations, the separation of ownership and control, and the development of securities markets have been particularly important for accountability and disclosure. There is little doubt that a highly influential factor in the United States, the United Kingdom, and other market economies was the recognition of corporations as legal entities with the public ownership of shares and the legal right of limited liability.

The characteristics of these early corporations necessitated disclosure to protect two groups in particular. First, as a consequence of limited liability, the resources available to creditors if the corporation were liquidated were limited to those of the corporation itself. Given that the liability of the shareholders was limited to their investment, disclosure was seen as a necessary means of regulation. Information disclosure, or “transparency,” would help creditors determine the extent to which they were prepared to commit resources to the corporation as well as the use of resources they had already committed.

The second major reason for the close relationship between limited liability and disclosure was the protection of shareholders. The emerging entrepreneurs often came from backgrounds that did not give them easy access to the capital necessary to launch and expand individual projects. The introduction of limited liability removed a major disability. Those who owned capital often were unwilling to become involved in what frequently were risky projects because they stood to lose not only their investment but the rest of their personal wealth as well. Limited liability restricted the potential loss to the investment in the corporation. Since many of these investors were not directly involved in the running of the business, it was considered essential for their protection that they should have access to information on a regular basis.

Accountability to those with a direct financial relationship with corporations has been strongly influenced by two other developments—the growth of professional management and the emergence of securities markets.

Professional Management

The separation of ownership and control of corporations appears to have resulted from the emergence of professional management composed of individuals whose positions of power within corporations stemmed from their possession of administrative and/or technical skills rather than ownership of the corporation's capital. The growth in size and the increasing complexity of business are the basis for the growth in the importance of management. At the same time, in many countries (e.g., Italy, Greece, Switzerland) most businesses are still family owned and financed, and, even where they are listed, control is retained by family holdings.

Whether, and to what extent, the separation of ownership from management and the division of the corporation into two essentially distinct groups result in behavior different from that of a corporation owned and controlled by the same persons is a matter of considerable controversy. Concern over the possibility of a conflict of interest when owners and management were different people and the bad experience of individual cases were further reasons for maintaining and expanding accounting and information disclosure. Owners could now be reassured that management was not behaving in a manner detrimental to the owners' interests.

Securities Markets

Corresponding to the growth in the number, size, and complexity of corporations was the demand for finance in the form of shares, or what is termed *equity investment*, as well as loans. This gave rise to the development of capital markets where the raising of finance could be facilitated. A major factor influencing accounting was the emergence of stock exchanges or securities markets, which have their origins in the desire of shareholders to trade their investments without liquidating the company, and the need for a mechanism to raise new finance in an efficient manner. The former reason, the exchangeability of shares, occupies the major portion of the market's time and energy, especially in countries such as the United States, the United Kingdom, and Japan. The relative market capitalization of the world's major developed securities markets is shown in Figure 1.3, from which it can be seen that the United States is dominant with a 43 percent share followed by Japan at 7 percent, to the United Kingdom at 20 percent, and France at 4 percent. The top five exchanges are the New York Stock Exchange, the London Stock Exchange, NASDAQ, the Tokyo Stock Exchange, and the Paris Stock Exchange.

There are also a growing number of securities markets that have been termed "emerging" markets (e.g., in China, Eastern Europe, Latin America, and the developing countries of Africa). Indeed, securities markets are seen to be fundamental elements of the transition to a market economy, which necessarily involves the privatization of state-owned enterprises and the need to attract foreign investment.

The growth of securities markets necessitated the expansion of information availability to a wider audience: in particular, potential investors interested in buying and selling shares. As most private shareholders were not capable of comprehensively analyzing the financial disclosures of corporations, they tended to rely on

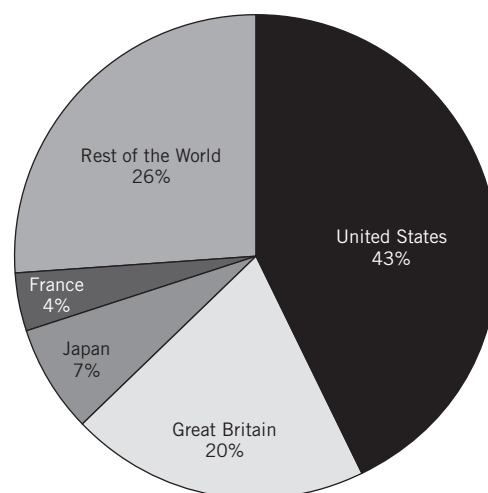


Figure 1.3 Market Capitalization by National Securities Market (Top 4 Countries)

specialist advisers and financial analysts. These analysts now act as interpreters of corporate reports for many investors, current and potential. In this way the information needs of investors, and financial analysts in particular, have acted as a constant pressure on corporations to increase both the quality and the quantity of their disclosures. Furthermore, it has often been in the interests of corporations and their managers, who are concerned to raise capital at favorable rates and to maximize the value of their corporation, to respond to such pressures. Thus, the emergence of securities markets has served to both deepen and broaden disclosure.

The importance of the information used by potential investors and the recommendations of financial analysts has meant that the financial disclosures of public corporations whose shares are traded have become publicly accessible. Corporate reports are available to groups other than investors and creditors not because of any pressure directly exerted by these groups but because of the necessity of available corporate information for unidentifiable potential investors. Indeed, many companies issue their reports on the Internet so that information is instantaneously available.

The predominant influence of securities markets and their regulatory bodies in determining the quality and quantity of publicly available information in corporate reports is reflected in the strong correlation between well-developed markets and the degree of financial disclosure in corporate reports. Countries with active and well-developed markets (e.g., the United States and United Kingdom) generally have a greater degree of public financial disclosure than those with relatively less developed markets.

Why is it that securities markets and the interests of shareholders/investors have apparently been the predominant force behind the emergence of public corporate disclosure? We have already argued that the existence of an active market necessitates the publication of financial information for share-trading decisions by shareholders and potential investors. What distinguishes shareholders from other finance providers is that most shareholders are “outsiders.” Despite being nominal

owners of the corporation, they have perhaps the least access to private information and arguably the least control unless they are institutional investors with significant shareholdings. The bargaining power of other finance providers (e.g., bankers) is such that these participants do not have to rely on published reports exclusively, if at all. In France and Germany, for example, the public ownership of shares in corporations is much less widespread than in the United States and the United Kingdom. In France, the government has played a major role in the supply of finance to corporations. In Germany, the banks are a significant source of loan finance and are often major equity investors in their own right.

These “other” finance providers generally have, as a result of their power, the ability to obtain considerably more detailed and up-to-date information than “outsiders.” Therefore, disclosure to finance providers can be seen as a spectrum: at one end, that of least disclosure, are shareholders and investors (with the exception of those who are directly involved with the company). Toward the other end, information disclosure is less restricted and varies in its nature depending on the purpose for which it is required and the power of the finance provider.

The myth that shareholders control public corporations still persists. Although this may be the case for small private corporations where the number of investors is limited, it does not apply, in the normal course of events, to large public corporations. Private investors in public corporations, where there is usually a widespread dispersion of share ownership, tend to exert little direct influence on the running of a corporation. These shareholders are usually passive, exercising their “power” on the advice and initiative of management (i.e., the board of directors).

The possibility of adverse changes in share prices may exert some indirect discipline on management, on account of their effect on financing potential and the possibility of takeover. But this is unlikely to be significant in countries where there are few shareholders and where securities markets are of relatively less importance as sources of finance (e.g., in many continental European countries).

Taking the place of the relative lack of influence of shareholders in many countries has been the influence of governments, as in France and Sweden, in the development and use of accounting systems that facilitate the provision of information for national economic planning and control. In France, for example, a uniform national accounting system was developed over the years as a basis for macro-economic planning and corporate taxation. For many governments, including France, Germany, Italy, and Japan, the collection of taxes is closely linked to information disclosed by companies in their published accounts. Hence, the tax rules have had a major influence on the accounting methods used. This is an entirely different orientation from the United States and the United Kingdom, where professional accountants have played a preeminent role in the development of accounting systems and forms of corporate reporting directed primarily to shareholders.

Trends in Securities Markets

There has been a strong move among securities markets to attract companies from abroad to list on their exchanges. In 2004, for example, the trading volume of non-U.S. firms listed on the New York Stock Exchange was 10.5 percent of the Exchange’s total trading volume. Although that is a relatively small percentage, that

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trading volume on its own would make trading in non-U.S. listed companies the second largest market in the world (<http://www.nyse.com/international/1088623922129.html>). However, the new Sarbanes–Oxley law on corporate governance and internal controls must be applied to foreign listers on any U.S. exchange, and the law is proving to be a barrier to attracting new business and even holding on to existing business.

Another trend in securities trading in Europe has to do with the consolidation of European stock exchanges. Prior to the 1999 introduction of the euro, the common currency used in Europe, there were 32 different stock exchanges in Europe. Three stock exchanges dominate trading in Europe—the Frankfurt Stock Exchange, the London Stock Exchange, and Euronext NV, which includes the French, Dutch, Belgian, and Portuguese stock and futures markets and the London International Financial Futures & Options Exchange, known as Liffe (<http://www.euronext.com/home/0,3766,1732,00.html>). Consolidation of other exchanges has taken place as well, such as the creation of Eurex, the joining together of the German and Swiss futures and options exchanges, which created the world's biggest derivatives exchange. The Finnish and Swedish exchanges also combined into one exchange called OMX AB. The move to consolidate derives from the increase in competition to offer the lowest fees for listing and trading securities (Ascarelli and McKay, 2005).

Markets in developing countries are growing as well. One reason is the overall growth in business and the desire of companies to access capital markets instead of relying on banks and family wealth. Another reason is the privatization of national companies as countries try to reduce budget deficits and get their economies under control. Also lurking on the horizon is China, which is opening up its borders to foreign direct investments and is increasingly changing its business model to that of a market economy. Even though the overall market capitalization of the developing countries is relatively small compared to that of the industrial countries, it is clearly increasing.

A Wider Audience

Accountability and information disclosure by corporations has developed historically in response to those with direct financial investment. In recent years, however, there has been an increasing acknowledgment that since finance providers, such as shareholders, bankers, lenders, and creditors, are not the only group affected by the actions of a corporation, there is an obligation to report to a wider audience, which includes employees, trade unions, consumers, government agencies, and the general public. There are a variety of reasons for this widespread belief that companies should explicitly disclose information to groups other than finance providers. One of the most significant reasons is the development and growth of the influence of trade unions and employees in most developed countries. They have been instrumental in voicing the view that those who are significantly affected by decisions made by institutions in general must be given the opportunity to influence those decisions. Furthermore, there is growing public concern about the impact of corporations on externalities (e.g., pollution of the environment and the influence of large corporations on national economic and social policies).

These developments, among others, have expanded the concept of “accountability” and the desire of various groups in society to monitor and influence the behavior of business corporations. Wider corporate accountability thus has become an issue of major interest in recent years. To what extent has it affected corporate reports? The development of accounting by corporations has been constrained by restrictions on both the supply and demand sides.

On the supply side, explicit acknowledgment of the “rights” of nonfinance providers, such as trade unions, to information may, for some corporations, mean that they would be committed to pursue goals other than those they have traditionally followed. From a managerial perspective, this could endanger the growth or survival of the corporation. The extent to which corporations’ behavior has been influenced in the goals of nonfinance providers is another matter. But many corporations, regardless of what they actually do, have been reluctant to formally acknowledge the influence of other “stakeholders.”

Corporate reports may be used as a source of information helpful for making decisions and reporting on management’s stewardship to finance providers. Increasing information disclosure to nonfinance providers may be seen as increasing the power of the recipients to influence the behavior of the corporation as well as providing material for criticism of the corporation’s performance.

A further constraint is that many of the expectations of nonfinance providers are not clearly defined, and the techniques to measure them do not exist. Although the information requests of finance providers relate to the periodic financial resources and position of a corporation and the results of its operations, many of the information requirements of nonfinance providers appear to relate to a corporation’s social as well as economic performance. Not only are measurement techniques often unavailable or underdeveloped but often there is not even general agreement on the broad elements of accountability involved.

On the demand side, information already made available to the public may satisfy the demands of the nonfinance providers, making additional information unnecessary. The disclosure of additional information may not be that helpful.

The ability of nonfinance providers to influence corporate behavior varies considerably. Those with limited or no influence can exert little direct pressure for increased disclosure, whereas those with some power may be able to bypass the published corporate report and obtain information directly, and in greater detail, in special reports. In many European countries, especially Germany and France, trade unions or employee representatives have, through various forms of “codetermination” or collective bargaining, obtained access to information. In Germany, for example, this right to disclosure is established in law, with works councils given access to a wide range of financial and nonfinancial information. The philosophy behind this is that such access will promote mutual trust between employers and employees. The availability of information for bargaining with corporations can be double-edged, however, in the sense that the information may not substantiate opinions previously held and could therefore reduce rather than enhance the influence of the user group concerned.

An acknowledgment of a right of access to information implies certain political values—essentially those of liberal democracies, like those established in Western Europe. In countries where democracy is not as well established (e.g., in some African countries), the conditions necessary for increased accountability and disclosure are considerably less well developed.

An Evolutionary Process

Public accounting and disclosure in corporate reports has been a spinoff from the evolution, over a considerable period of time, of accountability and disclosure to finance providers. The major impetus has been provided by the growth of active and well-developed securities markets. In many countries, such markets are not well developed, and while their limited maturity in this respect may not ultimately prevent wider disclosure, it would necessitate measures significantly different from those experienced in many of the developed countries.

ACCOUNTABILITY AND MULTINATIONAL ENTERPRISES

We have considered the evolution of information disclosure by enterprises, but we have not yet distinguished between those whose ownership and operations remain essentially in one country (i.e., domestic enterprises) and those that operate simultaneously in a number of countries (i.e., MNEs). What differentiates MNEs from domestic firms, and how do, or should, these factors affect the accountability and reports of MNEs?

Foreign direct investment (FDI) by MNEs entails certain benefits and costs for host countries. In this context, the demand for greater disclosure from MNEs may be viewed as part of a bargaining process—an effort by host countries, and developing countries in particular, to improve their bargaining powers. The fact that MNEs operate in a number of different nation-states has given them an opportunity to take actions in their own best interest that are not available to others. This is the basis for a conflict of perspectives between that of a national view of various groups within the nation-state and the multinational view of the MNEs. While business activities in a single country are for many MNEs just a part of their global operation, this is the part that is of primary concern for most of those affected in the host country.

The multinationality, size, and complexity of MNEs have enabled some of them to undertake actions detrimental to a host country. Cases of tax avoidance bordering on evasion, political interference, discriminatory practices, and so on are well documented. Whether these are exceptions or whether they represent more general practice is a matter of debate. The known cases, however, have been sufficient when combined with other factors to increase the pressure for greater accountability and disclosure.

Accountability by MNEs thus may be differentiated from accountability by domestic corporations, though both are business organizations with many features in common. A domestic corporation's primary operations are in one country, and its cross-frontier relationships are with unrelated parties. On the other hand, MNEs operate in a number of countries with different laws and currencies, and there is usually a significant volume of transactions between units located in different countries. The common control of these globally dispersed operations provides the opportunity to coordinate pricing, sourcing, and location decisions in a manner that, while increasing the net return of the group, may be detrimental or, alternatively, advantageous to individual nation-states. This special impact of MNEs appears to have given rise to pressure for more accountability and information disclosure.

ACCOUNTING ASPECTS OF INTERNATIONAL BUSINESS

A firm's first exposure to international accounting usually occurs as a result of an import or export opportunity. In the case of exports, a domestic company may receive an unsolicited inquiry or purchase order from a foreign buyer. Assuming the domestic company desires to make the sale, it needs to investigate the foreign buyer, particularly when the buyer asks for the extension of credit. This procedure is often not as easy as it appears.

First, the buyer may not be listed in any of the international credit rating directories, such as Standard & Poor's. If not, the seller may need to ask its bank to have its foreign affiliates check on the buyer's creditability. Alternatively, it may ask the buyer to supply financial information. The buyer may be willing to supply financial statements, but these statements may be difficult for the domestic company to interpret. The statements may be in a foreign language and may be based on accounting assumptions and procedures unfamiliar to the company's accountants. Most companies new to international business must then get help, either from a bank or from an accounting firm with international expertise. If the foreign buyer pays in its own currency, the selling company must become familiar with the potential gains and losses from changes in the exchange rate that may occur between the time the order is booked and the time the payment is received.

The selling company must also deal with a host of other international details—special international shipping and insurance documents, customs declaration forms, international legal documents, and so on. Once again, the services of lawyers, shippers, bankers, and accountants with international expertise are needed.

In the case of a potential import, the international accounting aspects are not as involved because most of the details are the responsibility of the foreign seller. However, if the foreign seller requires payments in his or her currency or if the domestic buyer wants information about the reliability of the foreign supplier, the buyer may need to consult an international bank, lawyer, or accounting firm.

Establishing an Internal International Accounting Capability

As the firm becomes increasingly involved in trade, the international accounting activity increases, and so do the costs of using outside expertise. At some point it becomes feasible for the company to develop the international capabilities of its own staff, including its own accountants.

The next major development that is likely to necessitate increased international accounting skills is the creation of a separate organization within the company to handle international trade. This may be an export department. Special accounting systems and procedures must be established in control, reporting, and taxation areas.

Typically, the next evolutionary step is the establishment of a foreign operation of some kind. In the minimal case, the company may decide to license a foreign manufacturer to produce its product or some part of its product. This involves selecting a potential licensee, analyzing its reliability and capability, and drawing up a contract. It also involves developing an accounting system to monitor contract performance and royalty and technical payments and to handle the foreign money flows into the company's tax and financial statements.

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At the other end of the spectrum, the company may establish a wholly owned subsidiary in a foreign country. Accounting for the foreign subsidiary would include (1) meeting the requirements of the foreign government, which would be based on procedures and practices different from those in the parent company's country; (2) establishing a management information system to monitor, control, and evaluate the foreign subsidiary; and (3) developing a system to consolidate the foreign subsidiary's operating results with those of the parent for financial and tax-reporting purposes.

Between these extremes are a host of alternatives: opening up a sales office, setting up a warehouse, forming a joint venture with another company, and buying into an existing company. Each brings with it new international dimensions and requirements for management and, more specifically, for the company's accountants. It should also be pointed out that, before any of this takes place, a thorough study of market conditions—legal, economic, political, and sociocultural—should be made, including detailed feasibility studies and risk analysis. All of these steps require the collection and appropriate analysis of information in both quantitative financial terms and qualitative terms.

During a first venture into any of these more advanced areas, the international expertise of outside groups can be indispensable because of the money and risks involved in international trade. However, using outside international experts in no way lessens the need to develop in-house international capabilities, not only in accounting but in other functional areas as well.

Finally, some knowledge of international accounting may be necessary even if a firm is not involved in international business per se—for example, if the firm wishes to borrow money or to buy or sell stocks or bonds outside its home country. In some cases, it may be cheaper to borrow money or issue stocks or bonds abroad because interest rates are lower or exchange rate movements are favorable. In order to take advantage of these situations, the firm needs to know not only the relevant foreign laws, regulations, and customs but also the domestic legal, tax, and accounting treatments of any of these transactions. Alternatively, there may be better investment opportunities abroad for short-term liquid funds because of higher returns, predicted exchange rate movements, or both.

From an investment standpoint, the firm must know exactly what it is doing as well as know all the attendant risks. This entails an understanding of the financial statements, the terms of the foreign offer, and foreign currency movements. And as was the case with raising capital abroad, the investing firm must understand both the foreign and domestic laws and the tax and accounting treatments of the transaction being considered.

THE FIELD OF INTERNATIONAL ACCOUNTING

The study of international accounting involves two major areas: descriptive/comparative accounting and the accounting dimensions of international transactions/multinational enterprises.

The first area is fascinating because it is fundamental to an understanding of the nature and uses of accounting. However, it would be impossible to study accounting for each country in the world in the same depth that one does for one's

own country. Although some description is necessary when studying accounting in different countries, the important issues are the forces and conditions that create international differences. Some countries, such as the United States, the United Kingdom, Germany, and France, are key countries to study because of their strong influence on the rest of the world. Colonial ties and direct investment require a basic understanding of those countries and their accounting systems. Even though it is important to understand the differences and unique aspects of accounting in different countries, the trend is toward convergence of accounting standards and practices internationally, especially for companies raising capital on national and foreign capital markets. Thus, the field of descriptive/comparative accounting is important as it relates to the convergence process.

Earlier we described the issues relating to international transactions and multinational enterprises. Obviously, firms that are not considered multinational enterprises are involved in import/export transactions and require special attention. However, multinational enterprises have these problems and a host of others. Financial reporting problems, translation of foreign currency financial statements, information systems, budgets and performance evaluation, audits, and taxes are some of the major problems faced by these firms.

Overview of the Text

International accounting should be studied in the context of MNEs from a strategic perspective. Thus, we focus on the strategies of MNEs and how accounting is relevant to those strategies. However, this focus on the strategic context of the MNE does not imply that we are ignoring other important international accounting perspectives. The book is divided into two parts. The first part focuses on financial accounting issues central to the financial reporting process and the convergence of standards and practices. The second half focuses on managerial, auditing, and taxation issues.

Chapter 1 not only sets up the logic for the book, but it also provides the general background on MNEs for students who have never taken an international business class. In addition, this chapter identifies the major environmental influences on accounting development.

In Chapter 2, we discuss different ways to classify accounting regimes in different countries, and we show how culture influences accounting systems. This chapter is important in understanding accounting systems and practices in different countries as outlined in Chapters 3 and 4.

Chapters 3 and 4 show why companies need to be aware of the different accounting systems and accounting traditions they face in different parts of the world. We concentrate on some important studies that have attempted to explain why accounting systems differ from one country to another. This chapter emphasizes the importance of understanding similarities and differences in accounting systems, particularly in the context of multinational strategy. We conclude with a discussion of some of the unique accounting traditions and underlying roots of practice in a number of important countries of the world with different cultural backgrounds. Chapter 3 focuses on accounting in a sample of developed countries, and Chapter 4 focuses on accounting in a sample of developing countries.

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Chapter 5 introduces techniques for comparing the financial statements of companies from different countries. We examine the extent to which international differences in accounting principles have an impact on measures of earnings and assets. Foreign companies that list their securities on a U.S. stock exchange must provide a reconciliation of their earnings and stockholders' equity to U.S. GAAP earnings and stockholders' equity, an important point of discussion in this chapter.

Chapter 6 deals with a number of important international transparency and disclosure and reporting issues, some of which are discussed in more detail later (e.g., segment reporting).

Chapter 7 examines the key international convergence issues at work in the world today. In particular, the International Accounting Standards Board is stepping forward to establish international reporting standards that can be adopted worldwide. It is working with, rather than competing with, the major national standards setters, including the Financial Accounting Standards Board in the United States.

Chapter 8 is the first of several chapters that examine important financial reporting issues. In particular, we discuss different consolidation methods that are used around the world, the importance of the equity versus the cost method, and the issue of whether or not companies should consolidate operations, especially foreign operations. In addition, we deal with some of the current issues arising in cross-border mergers and acquisitions. Issues involved in accounting for goodwill and intangible assets are also discussed, especially the advantages and disadvantages of alternative accounting methods relating to goodwill, brands and trademarks, and research and development costs.

Chapter 9, which discusses segment reporting, concentrates on the reasons companies are required to provide line-of-business and geographic segment information. New standards worldwide have caused this area to change dramatically in recent years.

Chapter 10 initially deals with accounting for foreign currency transactions and then examine how MNEs translate the results of their foreign operations and consolidate those results with domestic operations.

Chapter 11 concludes the discussion of key accounting concepts by looking at accounting for price changes and inflation. This is especially relevant in the context of foreign operations and foreign exchange accounting. Although inflation in general has fallen in recent years, it is never far away and must be addressed.

Chapter 12 begins a series of chapters discussing special managerial issues. Chapter 12, on corporate governance and control of operations, begins with a discussion of global strategy and structure and then moves on to corporate governance and control systems. Particular emphasis is placed on emerging research in the area of corporate governance internationally.

Chapter 13 builds on Chapters 10 and 11 by discussing foreign exchange risk management and the role of accounting in providing information to corporate treasury so that proper hedging strategies can be undertaken.

Chapter 14 focuses on international budgeting and performance evaluation issues and trends and on how companies coordinate these issues in a multinational environment.

Chapter 15 deals with the international auditing of foreign operations and concentrates on three key issues that relate to auditing: the nature of the account-

ing and auditing profession worldwide, the organization of international public accounting firms, and the harmonization of auditing standards and practices.

In Chapter 16, the final chapter, we focus on the multinational enterprise as it attempts to satisfy the tax codes in its own country and to operate in different tax environments around the world. We discuss some key issues relating to the taxation of exports and imports as well as the earnings of foreign operations. The chapter ends with a discussion of how firms can plan their operations in a complex international taxation environment.

SUMMARY

1. Although the recording of transactions is probably as old as the history of record keeping, we tend to think of the establishment of double-entry accounting, the basis for modern accounting, as the key event. Modern accounting originated in Genoa, Florence, and Venice and spread to the rest of the world thanks to the work of Luca Pacioli, the first person to document the double-entry accounting system.

2. The development of increasingly complex business practices constantly transforms and presents new challenges to the accounting profession.

3. One of the major developments shaping the accounting profession is the increasing globalization of business. The period after World War II, known as the multinational era, showed a strong increase in international trade and marked the appearance of very large multinational enterprises. This globalization presents new challenges for the accounting profession.

4. Accounting is influenced by a variety of environmental factors. These factors shape, reflect, and reinforce accounting characteristics unique to each national environment.

5. Major factors promoting the development of corporate reporting internationally include the ownership of stocks (shares) by the public, the growth of professional management, and the emergence of securities markets.

6. At the same time, major factors constraining public reporting and disclosure include the financing of business by banks and government agencies, the design of accounting information systems for government planning and control, and the influence of tax rules.

7. In recent years, a wider audience for corporate reports has been recognized, including employees, trade unions, consumers, government agencies, and the general public.

8. Accountability and disclosure pressures on MNEs are different from those on domestic corporations because of the global reach, size, and complexity of MNE operations.

9. As companies become more international, they face the challenges of developing internal expertise in international accounting practices to deal with currency fluctuations, different tax laws, legal systems, and the like.

10. The study of international accounting involves two major areas: descriptive/comparative accounting and the accounting dimensions of international transactions/multinational enterprises.

30 Chapter One International Accounting and International Business**Discussion Questions**

1. In your opinion, when did the practice of accounting begin? Justify your answer.
2. What conditions came together to make Italy, and specifically Venice, the birthplace of modern accounting?
3. Based on the brief history of accounting and business provided in this chapter, list some of the key historical events that have shaped the accounting profession so far. For each event, briefly explain how that event affected the practice of accounting.
4. Identify the most important business, cultural, and political forces at work in your own country. In your opinion, how will those developments affect the accounting profession?
5. What international pressures for change in accounting do you think are going to be most important during the early years of the twenty-first century?
6. How important a constraint on change are national cultural differences likely to be? Are cultures themselves changing? in what way?
7. The International Accounting Standards Board (IASB), based in London, England, was established with the goal of developing a set of international accounting standards to increase the comparability of financial reporting worldwide. Do you think this is a worthwhile goal? Why or why not?
8. Given the increased globalization of the last few decades, can small domestic business survive? What advantages and disadvantages do they have compared to MNEs? (*Hint: look at Figure 1.1.*)
9. One of the environmental influences on accounting is the existence of a sound infrastructure of accounting education and research. Evaluate accounting education and research in your own country. How could it be improved to prepare you to compete in an increasingly global economy?
10. Evaluate the political and legal systems in your country. Do they support or hinder the establishment of MNEs? Why?
11. How important is the stock market in your country? Is it getting more important? If so, how and why?
12. The chapter states that securities markets are crucial in promoting the development of external reporting systems. What role does accounting information play in securities markets?
13. Do companies have a responsibility to disclose information to nonfinance providers (the “wider audience” mentioned in the text)? If they do, what kinds of extra information should companies disclose to nonfinance providers?
14. What extra accountability obligations emerge when a company decides to grow outside of its home country?
15. Chances are you will someday work for a MNE. What accounting skills do you think you will need to succeed in an international environment?

Exercises

1. Based on the brief history of accounting and business provided in this chapter, list the key historical events that have shaped the accounting profession so far. For each event, briefly explain how that event affected the practice of accounting.
2. Make a list of the most important business, cultural, and political forces at work in your own country. For each item you listed, answer the following questions:
 - a. How will this development affect the accounting profession in this country?
 - b. How will this development affect the accounting profession in other countries?
3. In Chapter 7, you will learn more about the IASB. To familiarize yourself with this organization, do the following:

- a. Go to the IASB's website at www.iasb.org, find the purpose of the IASB, and summarize it in one paragraph.
 - b. Consider the economic, political, and cultural realities the world is facing today. Based on these considerations, do you think the IASB will accomplish its mission? What are the major threats this organization faces?
4. As the text mentions, more and more companies are conducting business in foreign countries. A distinguishing characteristic of MNEs is that they are listed on foreign stock exchanges. Go to the website of the New York Stock Exchange (NYSE) at www.nyse.com and find a list of all the foreign (non-U.S.) companies listed on the exchange. Answer the following questions:
 - a. Which foreign country has the most companies listed on the NYSE?
 - b. Which regions/continents are the most strongly represented on the NYSE? Which are the least represented?
 - c. Why are some regions of the world less represented on the NYSE?
5. Now that you have found foreign companies listed on a U.S. stock exchange, pick a stock exchange in a different country and find a list of the foreign companies listed on that country's exchange. You can find a list of world stock exchanges at www.fibv.com. Once you have done so, answer the following questions:
 - a. Which foreign country has the most companies listed on the exchange?
 - b. Which regions/continents are the most strongly represented on the exchange?
 - c. Why are some regions of the world less represented on the exchange?
6. Find out what listing requirements must be met by foreign companies wishing to be listed on your country's stock exchange. If your country does not have an exchange, you can choose another country's exchange. You can find a list of world stock exchanges at www.fibv.com.
7. Choose one of the MNEs from Exhibit 1.1. Find that company's most recent annual report on the web and answer the following questions:
 - a. What percentage of total revenues comes from foreign operations?
 - b. In what countries does the company operate? Why do you think it chose to expand into those countries?
 - c. To gather and summarize all the data required to create its annual report, the company you chose had to integrate financial information from various countries. What challenges do you think the firm faced in trying to integrate information from so many different origins?
8. The following statement is taken directly from the text:

There are also a growing number of securities markets that have been termed "emerging" markets (e.g., in China, Eastern Europe, Latin America, and the developing countries of Africa). Indeed, securities markets are seen to be fundamental elements of the transition to a market economy, which necessarily involves the privatization of state-owned enterprises and the need to attract foreign investment.

 - a. Do you agree with this statement?
 - b. Why is the existence of a securities market fundamental in a market economy?
9. As mentioned in the text, the influence of culture (i.e., societal or national values) is an important environmental influence on accounting traditions and practices. Religion has a strong influence on culture in some nations. For example, the laws and organizations of Islamic nations are based on the Muslim faith. The International Islamic University Malaysia has an Islamic accounting website found at <http://www.iiu.edu.my/iaw/>. Take some time to learn about Islamic accounting. How has the Islamic culture and religion shaped accounting in predominantly Muslim nations?
10. Toyota is a well-known Japanese automaker with operations in several parts of the world. At the end of the chapter is a case on *Toyota's Global Expansion*. Understanding the Japanese accounting environment will greatly aid you in preparing for this case.

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Visit <http://marriottschool.byu.edu/teacher/Acc645/account/Japan.htm> and read the article on Japanese accounting.

11. Ahold is a food products MNE based in the Netherlands. On the website is a case on *Ahold and the Challenges of Going Global*. Understanding the Dutch accounting environment will greatly aid you in preparing for this case. Go to the web and learn about accounting practices in the The Netherlands. Answer the following questions:
 - a. How do the legal system and culture influence accounting?
 - b. How does membership in the EU affect accounting practices?
 - c. How are accounting standards set?
 - d. What are some of the key accounting practices?
12. Consider the following statement:

Globalization refers to the deepening relationships and broadening interdependence among people from different countries. ... The growth of globalization creates both opportunities and threats for individuals, companies, and countries.

 - a. What are some of the opportunities created by globalization?
 - b. What are some of the threats posed by globalization?
13. Schering is a German company in the medical industry. In its 2003 annual report, the company disclosed the following information:

We have spent substantial amounts on environmental protection and safety measures up to now, and anticipate having to spend similar amounts in 2004 and subsequent years. In 2003, our operating and maintenance costs in the field of environmental protection and safety totaled €76m (2002: €74m). Our capital expenditure on environmental protection projects and other ecologically beneficial projects totaled €15m (2002: €15m). We estimate that operating and maintenance costs for safety and environmental measures will rise to between €76m and €80m annually by 2008. We expect capital expenditure on environmental projects and other ecologically beneficial projects to be between €5m and €15m annually over the same period. (Schering 2003 Annual Report)

 - a. Who would be most interested in this type of financial information?
 - b. Would this kind of information be valuable in determining the future financial performance of the company?
 - c. Why would Schering be interested in reporting about its environmental protection and safety efforts?
14. StoraEnso is a multinational Swedish company in the paper, packaging, and forest products industry. Along with its traditional annual report, the company publishes a Sustainability report for shareholders and the public. Visit www.storaenso.com and find the latest Sustainability report. Answer the following questions:
 - a. What is disclosed in the Sustainability report?
 - b. Why do you think StoraEnso spends so much time and energy on disclosing that kind of information?
 - c. Do you think disclosing that kind of information helps StoraEnso be more profitable? Why?
15. A new trend in investing is to look for companies that are not only profitable but also show a high degree of what is called corporate sustainability. Sustainability is a relatively new concept, but one that is increasing in popularity among investors and the general public. In response to this, Dow Jones created the Dow Jones Sustainability Indexes (DJSI). Visit www.sustainability-index.com and answer the following questions:
 - a. What is corporate sustainability?
 - b. How does the concept of sustainability create a demand for nontraditional financial information? How will this affect international accounting practices?
 - c. What does the DJSI measure? Why would corporations want to be a part of this index?
 - d. Find a list of current DJSI members. Do you recognize any of the companies?
 - e. Do you think firms will benefit from establishing sustainability strategies? How?

Case: Toyota's Global Expansion

Case: Ahold and the Challenges of Going Global

These cases can be found on the following website: www.wiley.com/college/radebaugh

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