INTERNATIONAL ACCOUNTING: AN INTRODUCTION

Accounting provides information about a firm and its transactions to facilitate resource allocation decisions by users of that information. If the information reported is reliable and useful, scarce resources are allocated in an optimal fashion, and conversely, resource allocations are less than optimal when information is less reliable and useful. International accounting, in some ways, plays the same role; only that the organization involved are either Multinationals or one with reporting responsibility to users in a foreign country.

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

The accounting in International accounting encompasses the functional areas of financial accounting, managerial accounting, auditing, taxation, and accounting information systems. The word *international* in international accounting can be defined at three different levels.

- The first level is supranational accounting, which denotes standards, guidelines, and rules of accounting, auditing, and taxation issued by supranational organizations. Such organizations include the United Nations, the Organization for Economic Cooperation and Development, Organization of Petroleum Exporting Countries and the International Federation of Accountants.
- At the second level, the company level, international accounting can be viewed in terms of the standards, guidelines, and practices that a company follows related to its international business activities and foreign investments. These would include standards for accounting for transactions denominated in a foreign currency and techniques for evaluating the performance of foreign operations.
- At the third and broadest level, international accounting can be viewed as the study of the standards, guidelines, and rules of accounting, auditing, and taxation that exist within each country as well as comparison of those items across countries. Examples would be cross-country comparisons of
    - i. rules related to the financial reporting of plant, property, and equipment;
    - ii. income and other tax rates; and
    - iii. the requirements for becoming a member of the national accounting profession.

Historical Perspective

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

To begin, double-entry bookkeeping, generally thought of as the genesis of accounting as we know it today, emanated from the Italian city states of the 14th and 15th centuries. Its development was spurred by the growth of international commerce in northern Italy during the late Middle Ages and the desire of government to find ways to tax commercial transactions. “Bookkeeping in the Italian fashion” then migrated to Germany to assist the merchants of the Fugger era and the Hanseatic league. At about the same time, business philosophers in the Netherlands sharpened ways of calculating periodic income, and government officials in France found it advantageous to apply the whole system to governmental planning and accountability. In due course, double-entry accounting ideas reached the British Isles. The development of the British Empire created unprecedented needs for British commercial interests to manage and control enterprises in the colonies, and for the records of their colonial enterprises to be reviewed and verified. These needs led to the emergence of accounting societies in the 1850s and an organized public accounting profession in Scotland and England during the 1870s. British accounting practices spread not only throughout North America but also throughout the British Commonwealth as it then existed. Parallel developments occurred elsewhere. The Dutch accounting model was exported to Indonesia, among other places. The French accounting system found a home in Polynesia and French-administered territories in Africa while the reporting framework of the Germans proved influential in Japan, Sweden, and czarist Russia. As the economic might of the United States grew during the first half of the 20th century, its sophistication in matters of accounting grew in tandem. Business schools assisted in this development by conceptualizing the subject matter and eventually having it recognized as an academic discipline in its own right on college and university campuses. After World War II, U.S. accounting influence made itself felt throughout the Western world, particularly in Germany and Japan. To a lesser extent, similar factors are directly observable in countries like Brazil, Israel, Mexico, the Philippines, Sweden, and Taiwan.

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

Resolving the historical paradox of accounting has long been a concern of both users and preparers of accounting information. In recent years, institutional efforts to narrow differences in measurement, disclosure, and auditing processes around the world have intensified.

CONTEMPORARY PERSPECTIVE

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

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

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

How Multinational Companies Evolve (An Example)

- **Birth of a company** (e.g. Dangote Group (1981); Globalcom (2003)
- **Import of raw materials and equipment**
- **Production and distribution of goods and services locally**
- **Expansion and growth**
- **Export of finished goods and services (Sales to foreign entities/individuals):**
  This brings about foreign currency sales. And with foreign currency sales come the need to account for issues arising from dealing with foreign exchange. A need for a domiciliary account and an account in the ledger showing that the amount receivable/received is in a different currency. Where transaction is done on credit, there arises a challenge if the exchange rate on the day of transaction is different to the day of receipt of payment. (Illustrate).
  The fluctuations in the rates of foreign exchange introduces foreign exchange risks. This is the risk that the foreign currency will decrease in naira (₦) value over the life of the receivable. While this risk can be avoided by insisting that such foreign customers pay in Naira, it will not always be possible to ensure/enforce that, particularly if the selling company really wants to expand in the international market.

Hedging: This is the reduction or elimination of the risk of loss arising from fluctuations in the exchange rate. Companies can use a variety of techniques to manage, or hedge, their exposure to foreign exchange risk. A popular way to hedge foreign exchange risk is through the purchase of a foreign currency option that gives the option owner the right, but not the obligation, to sell foreign currency at a predetermined exchange rate known as the strike price. Foreign currency forward contracts are another example of derivative financial instruments commonly used to hedge foreign exchange risk. This involves fixing a forward rate for the transaction in question. A forward rate is the rate quoted or agreed upon now for future delivery of currency between the parties involved.

The issues arising as a result of foreign exchange risks and hedging will not have come up, if the company restricts its operations to local sales and did not get involved with international trade.

- **Foreign Direct Investment (FDI):**

  As Dangote Cement continues to expand and export cement to Senegal, it discovered how lucrative the business is. Considering the increasing costs of transportation (shipping) and the fact that customers desire almost zero time lag between placing an order and its delivery; Dangote cement decided to install a cement manufacturing plant in Senegal. (One was actually opened in Senegal in 2015).

  FDI is the ownership and control of foreign assets, such as a manufacturing plant. And in other to achieve this a company may either purchase an existing production facility (acquisition) or construct a new plant (greenfield investment). In either case, the company would need to calculate the net present value (NPV) from the potential investment to make sure that the return on investment would be adequate. Determination of NPV involves forecasting future profits and cash flows, discounting those cash flows back to their present value, and comparing this with the amount of the investment. NPV calculations inherently involve a great deal of uncertainty. Computation of NPV assumes that there are detailed and reliable information about future cash inflows, which can be projected from past and present financial records. Further complexity comes in where these information (from the accounts) are not detailed.

  (Assignment: Identify and explain at least five reasons why companies engage in foreign direct investment).

- **Financial Reporting for Foreign Operations**

  As a publicly traded company in the Nigeria, Dangote Cement is required to prepare consolidated financial statements in which the assets, liabilities, and income of its subsidiaries (domestic and foreign) are combined with those of the parent company. And such consolidated financial st5atements must be prepared in line with the provisions of the Companies and Allied Matters Act and the International Financial Reporting Standards. Issues may arise where the Accounting standards between the two countries differ, and hence require reconciliation by accounting experts with a good understanding of what is obtainable in both countries. In addition to this, the accounts of the foreign operation will have to be translated into naira, which is the reporting currency in Nigeria. As a result of translation, further issues arise as to how to handle exchange differences (which comes about as a result of the different exchange rates used for different elements of financial statements).

- **International Income Taxation**

  The existence of a foreign subsidiary raises two kinds of questions with respect to taxation:

  1. What are the income taxes that Dangote Cement has to pay in Senegal, and how can those taxes legally be minimized?
  2. What are the taxes, if any, that Dangote Cement has to pay in Nigeria related to the income earned by its operation in Senegal, and how can those taxes legally be minimized?

  Issues of Double taxation relief will arise here as well

- **International Transfer Pricing**

  Some companies with foreign operations attempt to minimize the amount of worldwide taxes they pay through the use of discretionary transfer pricing. Where, for example, the tax rate is much higher in Senegal than in Nigeria, Dangote Cement in Nigeria will issue materials and goods to its operations in Senegal at relatively higher price. This will have the effect of shifting more expenses to Senegal and more gross profits to Nigeria; thereby reducing the total profits paid to both countries.

- **Performance Evaluation of Foreign Operations**

  To ensure that operations in both the Nigeria and Senegal are achieving their objectives, Dangote's top management may request that the managers of the various operating units submit periodic reports to headquarters detailing their unit's performance. Headquarters management is interested in evaluating the performance of the operating unit as well as the performance of the individuals responsible for managing those units. The process for evaluating performance that Dangote Cement has used in the past for its Nigerian operations may not be directly transferable in evaluating the performance of Dangote Cement, Senegal. Several issues unique to foreign operations must be considered in designing the evaluation system. For example, Dangote Cement has to decide whether to evaluate its Senegal operations' performance on the basis of CFA Franc or the naira. Translation from one currency to another can affect return-on-investment ratios that are often used as performance measures.

- **International Auditing**

  The primary objective of Dangote's performance evaluation system will be to maintain control over its decentralized operations. Another important component of the management control process is internal auditing. The internal auditor must

i. make sure that the company's policies and procedures are being followed, and
ii. uncover errors, inefficiencies, and, unfortunately at times, fraud.

There are several issues that make the internal audit of a foreign operation more complicated than domestic audits.

Perhaps the most obvious obstacle to performing an effective internal audit is **language**. To be able to communicate with managers and employees in Senegal — asking the questions that need to be asked and understanding the answers— Dangote Cement Nigeria's internal auditors need to speak French. The auditors also need to be familiar with the local culture and customs, because these may affect the amount of work necessary in the audit. This familiarity can help to explain some of the behavior encountered and perhaps can be useful in planning the audit. Another important function of the internal auditor is to make sure that the company is in compliance with the regulations imposed by CAMA and other laws in Nigeria. This may involve putting internal controls in place. External auditors encounter the same problems as internal auditors in dealing with the foreign operations of their clients. External auditors with multinational company clients must have an expertise in the various sets of financial accounting rules as well as the auditing standards in the various jurisdictions in which their clients operate. Dangote's external auditors, for example, must be capable of applying Senegalese auditing standards to attest that Senegal operation's financial statements present a true and fair view in accordance with Senegalese Accounting principles and standards. In addition, they must apply Nigerian auditing standards to verify that the reconciliation of the foreign operation's financial statements for consolidation purposes brings the financial statements in compliance with Nigerian GAAP. As firms have become more multinational, so have their external auditors.

Today, the Big Four international accounting firms are among the most multinational organizations in the world. Indeed, one of the Big Four accounting firms, KPMG, is the result of a merger of four different accounting firms that originated in four different countries and currently has offices in more than 150 jurisdictions around the world.

- **Cross-Listing on Foreign Stock Exchanges**

  As a result of its continued success in the international markets, apart from being listed on the Nigerian Stock Exchange, Dangote Cement is seeking to be listed on the London Stock exchange. Already Dangote Cement has operations Ghana, South Africa, Tanzania, Senegal and some other African countries. Further successes may still see it listed on the New York Stock exchange and others across the world.

Most stock exchanges require companies to file an annual report and specify the accounting rules that must be followed in preparing financial statements. Regulations pertaining to foreign companies can differ from those for domestic companies. Many stock exchanges around the world now allow foreign companies to be listed on those exchanges by using standards developed by the International Accounting Standards Board (IASB); that is the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS).

This eventually brings an MNC to the point where it becomes an advocate of **global accounting standards.**