1967

Reporting on international operations in annual reports

Charles E. Wieser

Recommended Citation
Quarterly, Vol. 13, no. 4 (1967, December), p. 34-37

Reporting on International

In recent years a growing number of United States companies have substantially increased their total dollar investment in international operations. This increase has represented an attempt by businessmen to participate in the rapidly expanding economy of the overseas markets where private capital is not as readily available as it is in the United States. The continuation of this growth will depend primarily on the policies of the U. S. government concerning overseas investment. To the extent that expansion of overseas facilities requires a further investment of U.S. dollars this growth may be curtailed significantly. Previously established overseas operations, however, and new organizations formed with accumulated earnings from such operations, will undoubtedly provide an element of growth in the years to come.

As the investment in international operations increases it becomes necessary to review the reporting policies and disclosure requirements relating to this phase of the business organization. At the present time, the methods used to report international operations are almost as numerous as the number of companies involved.

Charles E. Wieser, administrative manager in the Detroit office, joined Touche, Ross in 1954 after receiving B.S. and MBA degrees from Ohio State University. He is a member of the American Institute of CPA's, the NAA, the American Accounting Association, and the Michigan Association of CPA's where he is currently serving on the Committee on Auditing Practices.

The variety of reporting and disclosure practices is probably due to the individual peculiarities of the operations, methods of control, and how familiar company management is with the operations in each instance. Another, and perhaps more significant, reason for this difference in practices is the general feeling of caution relating to any overseas operation . . . possibly because it is "foreign" and therefore somewhat mysterious.

This cautious attitude is reflected, for example, by the American Institute of Certified Public Accountants in Chapter 12 of its last edition (1961) of the *Accounting Research and Technology Bulletins.* Although there is agreement that there should be disclosure of foreign assets and operations if they are significant, the discussion indicates that careful consideration should be given the question of the propriety of consolidating the statements of foreign subsidiaries. When one reviews the background of this research, it appears that the original consideration was the appropriate handling of exchange losses as a result of devaluations of foreign currencies. This problem, in view of the world monetary situation at that time, apparently prompted the very cautious approach which was appropriate then. In the light of present circumstances, however, it seems appropriate to reevaluate that philosophy.

COMMON PROBLEMS OF U. S. BUSINESSMEN ABROAD

There were significant problems that confronted the United States businessman in his first attempts to establish, operate, and control a business enterprise in another country. In most cases laws and legal systems were different from those to which he was accustomed. Differences in government control of accounting practices, local taxing regulations, international tax treaties, and customs of the taxing authorities presented a variety of complications. These problems were in addition to the general operating problems of business tradition, background of the people (both employee and customer), sales techniques, production methods, and labor practices. In non-English speaking countries, the language difference caused some difficulty. A particular barrier

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was the translation of some commonly used business terms with no direct English counterpart, to a terminology that was mutually understandable.

Financial and accounting requirements for evaluation of overseas operations were affected both directly and indirectly by all of these differences. For one thing, accounting philosophies and principles were not as well defined in most countries as in the United States. This was understandable when one considered that the equity capital market in most of these countries is not as well developed as in the United States. The traditional source of capital in these countries is borrowing from financial institutions, i.e., "debt capital" as opposed to "equity capital." The varying stages of development of accounting principles and the differing accounting practices required that the accounting and internal control system be very closely monitored by the parent company if results of operations were to be meaningful to management.

Through time, experience, and changes many of these problems have been resolved. The fact that solutions to such problems have been found, or alternative procedures designed, is evidence of the U. S. businessman's ingenuity and maturity in handling problems of this nature. This does not mean that all problems have been solved or that a solution is readily available for every problem. It does indicate, however, that an approach to problems of this type has been developed and has been found effective in many cases.

Many of the problems, for example, of operation, control, and communication have been or are being resolved. Internal reporting for management purposes and detailed financial information reliability have been developed to an acceptable level. The next logical step is to create the proper method for reporting financial information relating to these international operations in published financial statements. Although this is only part of the overall consideration of reporting on investments in subsidiaries and affiliated companies, it is considered here separately because of the peculiar problems of exchange rates and methods of operation as described above. This problem was not significant in the past because of the comparatively minor role these operations played compared with the total operations of the company.

Since the U. S. businessman has made great progress in coping with and solving the major problems encountered in the international operations of his business, it seems appropriate that the accounting profession provide assistance in the form of guidelines for the proper reporting of these operations.

PROPOSED REPORTING PRACTICES:

What then should be included in the financial statements of the international organization?

It is generally recognized that the proposed uses of financial statements determine to a large degree the best method of presentation. Enough information should be presented in the published annual report to permit an evaluation of management's effectiveness. It is a responsibility of management to utilize the assets under its control in the most effective manner. If this has not been accomplished, management has not discharged the responsibility assigned to it by the stockholders. Information of this nature should be included in the annual report, therefore, in an understandable manner. Information relating to the status and operations of the parent company only, the parent company and domestic subsidiaries only, or the parent company and selected subsidiaries only cannot provide the necessary information for a proper evaluation of the company or management if significant amounts relating to the international phase of the business are not included.

In order that financial statements in annual reports to shareholders present the financial information in the most complete and understandable manner, it seems appropriate to start with the basic premise of complete consolidation of all assets under management's control and the disclosure of results from all operations which have been directed by management.

A policy of this kind might at first appear to be unnecessarily restrictive, but on reflection will seem reasonable. The basic consideration is one of control. If management has control over the utilization and disposition of assets of an enterprise in another country and directs the operations of that company, then it should be judged on its ability to manage that company in the same manner it is judged on its effectiveness in managing the parent company.

TO CONSOLIDATE OR NOT

Many reasons have been cited in the past for not consolidating subsidiaries outside of the United States. The most common are simply because the companies are outside of the United States or because of their particular geographic location. Other reasons for exclusion include the degree of control by the parent company, the extent to which the subsidiary is an integral part of the operating group, and non-homogeneous operations. As a practical matter, none of these reasons are valid if there is effective control. For this purpose, effective control may be defined as the ability to direct the operations of the company and to control its policies.

As a corollary, lack of control of the organization provides a very real basis for not including the assets and results of operations of the company in consolidated financial statements. This lack of control may develop from restrictions imposed by the country's government or from other regulations that limit the effectiveness of management.

The above-mentioned factors serve to illustrate the circumstances that should affect a consolidation policy. The important fact is not that the organization is outside of the United States, in a particular geographic area, or that the parent company owns a given percentage of stock. Rather, the question should be does the parent have the ability to control and direct the policies and operations of the company. If the management of the parent company has this capability, then the responsibility for the effective discharge of the duties of management should follow.

The practical validity of this suggested policy rests on the contention that it would result in a more meaningful report to shareholders, prospective investors, other interested businessmen, and to the management of the company itself. It would also provide the basis for a more valid comparison of the financial results of various companies.

THE MOST MEANINGFUL METHOD OF CONSOLIDATION

Presently, the variations in consolidation policies and the amount of disclosure in annual reports of international operations confuse rather than assist the reader in an evaluation of financial results. The following chart sets forth certain assumed information of an organization with both domestic and international operations. The subsequent discussion considers some of the more common reporting practices used to present such information and the usual variations in interpretation.

There are three basic consolidation policies that may be used to present this information to shareholders in an annual report published by the organization. These are:

A. Include all domestic subsidiaries and report investments in international companies at cost.

B. Include all domestic subsidiaries and report investments in international companies at equity in net assets.

C. Consolidation of all domestic and international companies.

Some of the statistical relationships that would be reported under the three policies above are compared as follows:

	A.	*B.*	*C.*
Net income to sales	6.54%	7.44%	5.83%
Net income to total assets	10.25	9.14	9.21
Net income to shareholders' investment	18.08	15.55	15.55

These statistics are not all that are considered in an evaluation of financial information but they do illustrate the differences that can arise as a result of different consolidation policies.

Under policy A. above, there might also be a note to financial statements to indicate that, in addition to net income reported in the financial statements, the international companies' net earnings were $8,500,000. Although these "unreported" earnings might seem to be an additional advantage based on the method of reporting, they may actually represent the results of poor man-

	Domestic Companies	International Companies	Consolidated
AMOUNTS:			
Sales	$940,000,000	$260,000,000	$1,200,000,000
Net income	61,500,000	8,500,000	70,000,000
Total assets*	600,000,000	230,000,000	760,000,000
Shareholders' equity	340,000,000	110,000,000	450,000,000

* Cost of investments in international companies — $70,000,000.

PERCENTAGES:			
Net income to sales	6.54%	3.27%	5.83%
Net income to total assets	10.25	3.70	9.21
Net income to stockholders' equity	18.09	7.73	15.56
Percentage of consolidated net income to domestic sales (investment in international companies earned at equity in net assets)			7.44%

agement or ineffective utilization of assets if all the facts were known.

Policy B. above presents the most impressive percentage of net income to sales, however these are not comparable amounts in that "total net income" is related to "sales of domestic companies" only. This comparison is, of course, not valid from the standpoint of an overall evaluation of management performance.

These variations in reporting details of results of operations arise from one hypothetical case. They represent only three comparatively clear-cut, basic alternatives. As a practical matter, investors, analysts, bankers, and others must evaluate numerous companies with many variations and combinations of consolidation policies. Their task is almost impossible because of its complexity and lack of appropriate information.

The case illustrates the need for a firm set of rules established for consolidation practices. In addition, some suggested requirements for disclosure of pertinent information need to be developed and implemented.

Up until now the accounting profession, working with businessmen, has taken the lead in establishing accounting principles and financial reporting practices that have been an important factor in the development of our large domestic equity capital market. This leadership can and should be utilized now to establish revised principles and reporting requirements, as necessary, for overseas operations.