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Financial Statements For The Transnational Enterprise

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The Transnational Enterprise

Since the end of World War II United States corporations have, at an increasing rate, moved some of their operations into other countries. At the present time many of them hold 51% or more of the stock of companies abroad. As the economies of other nations approach a state of maturity, it may be expected that corporations of these countries will follow the pattern established by United States business and seek to expand their operations into world markets to the best of their ability. There are already numerous firms chartered in various European countries which have extensive holdings outside of their national borders. In the future there will be an increased number of companies which have stockholders in many countries, which are manned and managed by persons of many nationalities, which are operated all over the world, which have diversified products and fields of interest, and whose managers are trained to look at the world as an economic unit. Such a company has been termed a transnational enterprise.[1]

The Difficulty of Finding Common Denominators

There are, of course, numerous difficulties involved in the formation and operation of transnational enterprises, one of which is the problem of expressing its financial condition and the results of operations in such a way as to make them easily understood by stockholders of many different nations. There are differences as to the language because the books of the transnational enterprise will normally be kept in the language of the country where its particular local operations are situated. There are differences as to monetary units since a sale made in Holland would be recorded in guilders and one made in India, in rupees.

The two differences mentioned above, as to language and currency unit, are immediately apparent because they appear on the face of every financial report. Not as easily visible are the concepts which underlie the words and figures. For instance, the term "Retained Earnings" can be translated into any language. But what does the translated term mean to a German shareholder when there is no retained earnings concept in German accounting?

Likewise, currencies of one country may be translated, through the vehicle of the foreign exchange rate, into money units of another country. Technically, this presents no problem. However, questions arise as to the validity of the translation for numerous reasons, such as, for instance, possible differences between the official exchange rate and a so-called black market rate which may be much more closely related to the real worth of a currency than the official rate. Even if the official exchange rate has been established on the basis of supply and demand and thus represents a fair exchange rate, the results of translation may appear distorted. For example, there may be vast differences in the wage level of different countries. The balance in an account such as Direct Labor when translated from, say, yen into dollars does not truly reflect the utility added to raw materials when viewed by an American shareholder. The intrinsic value of any monetary unit is seldom apparent after translation since the monetary unit is only a symbol for economic goods and utility which loses its identity when the symbol takes on a different meaning to another person.

The solution to this problem would be the creation of a symbol which has the same significance to citizens of all countries. Since existing currencies carry certain implications in the eye of the beholder, the use of a new currency which may be purely fictional would be beneficial. Such a currency would facilitate a fresh approach to understanding valuations on the financial statements of international companies. More will be said about this later.

[1] Donald P. Kirchner, "Now the Transnational Enterprise," Harvard Business Review, March-April 1964, pp. 6-8, 10, 172, 174, 176.

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The Traditional Use of Exchange Rates

Assets and liabilities stated in foreign currencies which are to be translated normally came into being over a number of years. Consequently, in times of rising prices all over the world, the older balance sheet items are often greatly understated. In addition, the exchange rates themselves may have changed over a period of time.

Traditionally, accountants have tried to restate foreign assets and liabilities in United States dollars of current value by using exchange rates of different dates. Some authorities propose the use of the rate of exchange prevailing on the date of the balance sheet for current assets, and for fixed assets the rate prevailing at the time of acquisition.[2] Others hold that the distinction between current and fixed assets is unrealistic and that monetary assets and liabilities should be translated at the current rate, and non-monetary balance sheet items at their historical rates.[3]

The exchange rate, however, is not designed for and is not effective for converting foreign items of mixed values into one meaningful dollar figure. Such a conversion can only be accomplished through an adjustment of the foreign items for price-level changes. The subject will be discussed further under that topic.

The Problem Regarding Accounting Principles

As stated above, the transnational enterprise is one which is operated and owned internationally. Suppose, for the purpose of illustration, that twenty per cent of its operations are located in the United States, thirty per cent in France, thirty per cent in Germany and twenty per cent in Liberia. Forty per cent of the stockholders live in the United States, forty per cent in France and twenty per cent in Germany. Accounting principles are markedly different in certain respects in these countries. How can meaningful financial reports be prepared under these circumstances? Should four statements be prepared for each operation on the basis of local accounting principles and sent to all stockholders? Or should these four financial statements be consolidated regardless of underlying accounting principles? If one set of accounting principles is applied to the financial statement as a whole, whose principles should be used?

There has been more accounting research in the United States than in any other country. Whether its generally accepted principles and practices are better than those designed abroad is another matter. There are those who will argue the point. Foreign accountants often take exception to such things as the use of the LIFO inventory method, treatment of stock dividends, and a too rigid adherence to the historical cost principle.[4]

Regardless of the individual merits of each country's concept of generally accepted accounting principles, it is not likely that these would be easily adopted by another country. In the past, accounting principles have crossed international borders when they were following large amounts of investments and when the country receiving the investments had no organized body of accounting principles. This situation does not normally prevail in the case of the transnational enterprise and the selection of appropriate accounting principles presents an important problem

The development of "internationally accepted accounting principles" would constitute the ideal solution. That the formation of such principles is not currently within the realm of possibilities is a fact that is brought out by the sluggish or non-existent reaction on the part of the accounting profession to proposals made by Kraayenhof and Mueller regarding an exchange of research findings and the development of greater uniformity in the field of accounting principles.[5]

In the absence of the probability of an early adoption of internationally accepted accounting principles, an attempt should be made to reach an agreement between accounting bodies of different countries regarding accounting standards. Perhaps this would be easier to do for form than for substance of annual reports. In any case, any steps taken in this direction would at least get things under way and would lead, hopefully, to more international uniformity in accounting.

Which Currency Should Be Used?

Presently, when financial statements prepared in different countries are consolidated, various practices are being followed

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[2] American Institute of Certified Public Accountants, Accounting Research Bulletin No. 43, Chapter 12.

[3] Samuel R. Hepworth, "Reporting Foreign Operations," Michigan Business Studies, Volume XII, Number 5, Ann Arbor, University of Michigan, 1956.

[4] For more comprehensive treatment, see Theodore L. Wilkinson, "U.S. Accounting As Viewed From Other Countries," Price Waterhouse Review, Summer 1964.

[5] Jacob Kraayenhof, "International Challenges for Accounting," Journal of Accountancy, January 1960, pp. 34-38 and Gerhard G. Mueller, "Some Thoughts about the International Congress of Accountants," The Accounting Review, October, 1961, pp. 548-554.

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An alternative solution to the problem of a corporation that is faced with the dilemma of a Section 531 problem is the election of Subchapter S status within the first thirty days of the 1967 year. Here, however, the shareholders are compelled to pick up in their individual returns the entire net income of the corporation whether or not distributed. The election negates the possibility of retention of possible future profits, should it be justified.

D.L.B.

Trends of Special Interest to the Accountant in Financial Reports

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In the booklet recently published by the American Accounting Association, "A Statement of Basic Accounting Theory," it is suggested that both historical cost and current cost be presented in adjacent columns and that current cost be secured by reference to established market price or through application of a price index to acquisition cost.

With the stress on the usefulness of financial reports comes the realization that there is a decided trend toward getting away from using technical terms that do not have precise meaning. Though there is a natural desire to reduce to a minimum the number of words used, there has been increasing growth in the footnote area and in the number of statements that show the explanations of the items directly below each title. Improvements in format, content, and other facets of the published annual report are part of management's continuous effort to maximize communication with stockholders.

In some minds, the earnings-per-share statistic is the figure that is accepted as summarizing all activity. Investment decisions are made accordingly with no consideration given to the possibility that a portion of the earnings-per-share amount may be due to income from unusual transactions and with a complete disregard of all other pertinent data. Thus, as another step in improved reporting, it is suggested that where applicable in the presentation of the earnings-per-share figure, the portion of this figure contributed by net income from operations and the remainder derived from income due to unusual transactions be separately stated. More detailed information will be forthcoming if the SEC concludes, as the result of a current study, that sales and profits for specific lines and services should be shown in detail. Concurrently, some writers of financial articles are stressing the need for presentation of individual company statements as well as the consolidated statement in cases where the individual statements are more meaningful.

The comparative financial statements that are a popular presentation in today's financial report may someday be replaced by financial statements showing a ten-year span with explanatory commentary by management as to the cause and significance of fluctuations. Increasing international business and investments augment the possibility that the present problems of uniformity and comparability in financial reports will be shifted from the local and national scene to an international setting. The present views in disputed accounting areas are surprisingly divergent, but they pose as a necessary forerunner to more profound research into what is needed. Accountants may differ as to the proper course of action, but there is evident an underlying general agreement that there will be expansion of the accounting discipline to give more information and to move ultimately toward international uniformity of accounting and auditing standards.

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as to currency shown. Where United States corporations hold 51% or more of the stock of a foreign subsidiary, the United States dollar is used in the statements. Companies of two foreign countries consolidating their financial statements frequently use a fictional monetary unit, such as the Eurodollar which is based on the gold standard. Finally, there are corporations whose management believes that a translation of one currency into another is not meaningful.

A Fictional Currency

As brought out above, the transnational enterprise must arrive at some common denominator in the preparation of its financial reports. Since in all likelihood a number of different currencies are involved, it seems logical that the use of a fictional currency might be of great help.

There are several advantages to employing a fictional monetary unit. The use of any one country's currency might meet considerable resistance because it would seem to give this country a special position of importance or superiority over other nationalities' interests in the enterprise. A fictional currency cannot be opposed on the basis of nationalistic feelings. Secondly, a fictional, imaginary monetary unit is not subject to fluctuating exchange rates set by national governments. If its value were related

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to the price of gold, it would have additional stability. Thirdly, an imaginary unit may be used by all transnational enterprises regardless of the location of their operations and shareholders, and would therefore contribute to the comparability of their respective financial statements.

Adjusting for Price Level Changes

The accounting profession in the United States has been concerned about inflation for a long time. Various studies have been made on accounting for price-level changes but have brought about no changes in accounting principles in the United States.

Accountants abroad have been much more progressive, perhaps mainly because the faster rate of inflation in their countries forced them to adjust accounting concepts. In most instances, accountants of other countries expressed historical costs at the new values of their respective currencies. The Dutch went one step beyond this and are using replacement costs in revaluing assets.

As far as finding a basis for a valuation of the assets and liabilities of transnational enterprises is concerned, neither unadjusted historical cost nor replacement value seems suitable. Domestic financial statements based on historical cost reflect a mixture of currency units of different value, and such a mixture does not normally result in meaningful figures. The use of unadjusted historical cost in reports of the transnational enterprise is even more unrealistic because a great many currencies may be involved, some of which have experienced drastic changes in value. The replacement value method, while it seems to work very well in The Netherlands, has not found acceptance anywhere else.

One method that satisfies the need for an adjustment of the accounts to changes in the purchasing power of money and yet does not stray too far from accounting conventions is the valuation of assets and liabilities based on historical cost adjusted for price-level changes. This method has the advantage of majority approval since it is now in use in most countries. Should Accounting Research Study No. 6 be approved by the Accounting Principles Board, United States accountants should have no objections to employing historical cost adjusted for price-level changes in the reports of international enterprises.

The procedure of adjusting for price-level changes is conservative in that it does not abandon cost concepts. It is progressive because it does recognize that currencies expended in different years carry different values and it adjusts them accordingly.

Exchange Rates

After the accounts have been adjusted for changes in the purchasing power of money (needless to say, this would not normally be done in the books of account but only for the purpose of preparing financial statements), it must be determined which exchange rate should be used in order to translate the respective currencies into that fictional unit which is to serve as the common monetary unit in the report of the transnational enterprise. Since all accounts before translation have already been expressed in money of uniform value, the exchange rate no longer has the function of converting monetary units of differing value of one currency into monetary units of uniform value of another currency. Consequently, the selection of the proper exchange rate no longer poses a difficult problem. All items in the financial statements may be translated at the current rate.

The translation of currencies often results in gains or losses, the disposition of which poses additional problems. A discussion of alternative treatment of these translation gains and losses is beyond the scope of this article.

Conclusions

The method of preparing financial statements for the transnational enterprise which has been outlined is fairly simple and straightforward. Such statements satisfy the need for consistency and comparability. They are based on the cost principle which is in effect in a majority of countries. They are relatively free from distortions.

While the underlying accounting records would be kept in accordance with local law and custom in order to comply with the various government regulations in effect, the financial statements would be designed to afford the stockholders of the transnational enterprise a better understanding of the condition and results of operations of the corporation in which they have invested their funds.

Everybody Talks About It

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summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.[21]

[21] Committee on Terminology, *op. cit.*, p. 9.

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