Woman C.P.A.

Volume 51 | Issue 4 Article 4

10-1989

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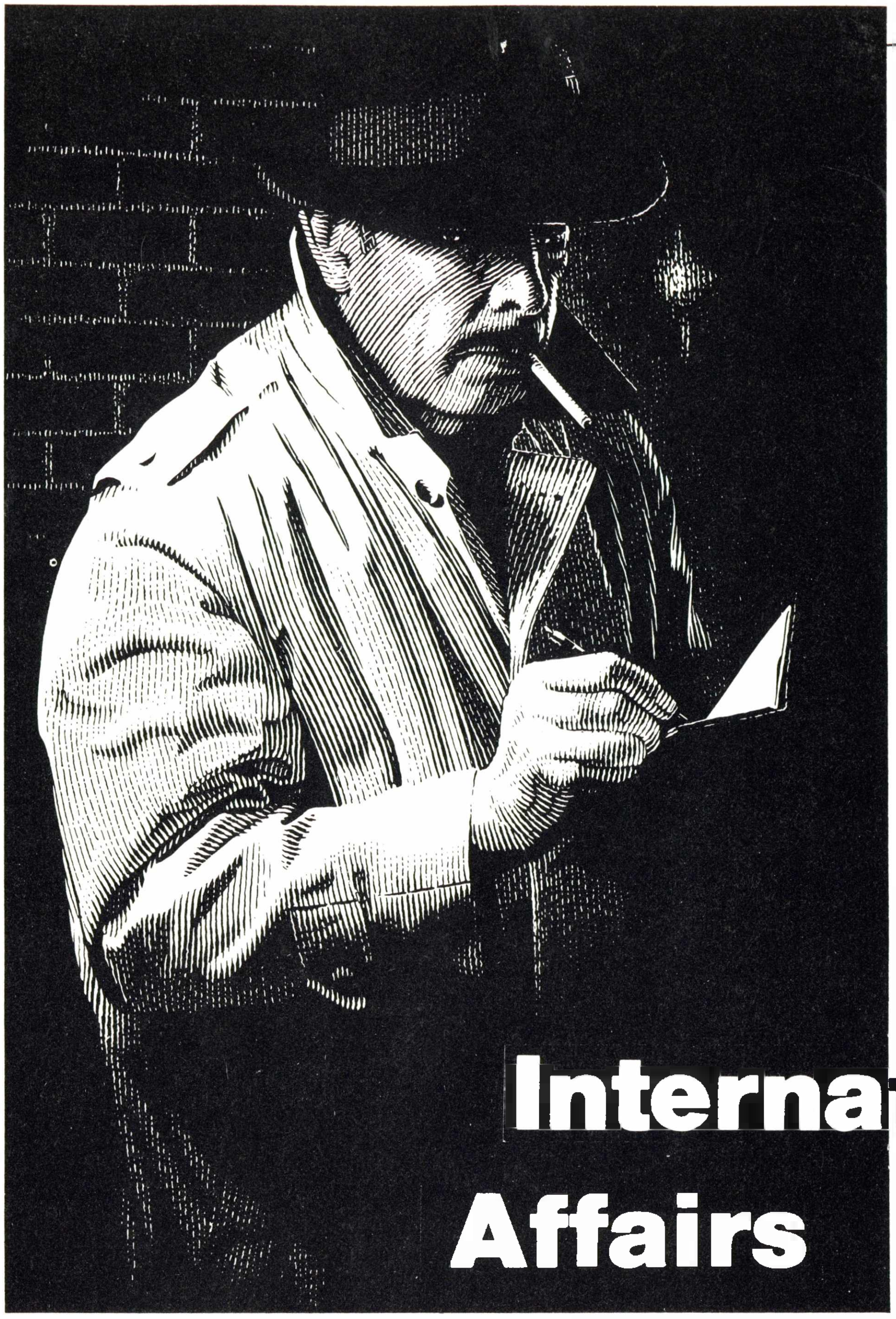

International Affairs

How Much Is Known?

By Kathryn L. Pfirman and Dahli Gray

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Introduction

Preparers of financial reports advocate flexibility because financial circumstances differ. In contrast, investors and analysts advocate comparability, which is enhanced when flexibility is minimized. The Financial Accounting Standards Board (FASB) is trying to strike a balance in this struggle but often finds itself in a precarious situation. Certain accounting standards promulgated by FASB limit alternatives while other standards allow or even encourage flexibility. Among the latter is Statement of Financial Accounting Standards (SFAS) No. 14, *Financial Reporting for Segments of a Business Enterprise*, issued in December 1976. This standard applies to public companies only and addresses disclosure of business segments, foreign operations, sales to major customers, and export sales. This article examines and discusses the flexibility in financial reporting of foreign operations by multi-national corporations (MNCs). An analysis of foreign operations disclosure reveals that several methods of geographic segmentation are employed with grouping by continent being the most prevalent.

SFAS 14 and Foreign Operations Disclosure

Foreign operations are deemed significant and must be disclosed for each significant geographic area if either of the two following conditions are met:

a. Foreign revenue is 10% or more of consolidated revenue

b. Foreign assets are 10% or more of consolidated assets [SFAS 14, p. 153]

If foreign operations are carried out in only one geographic area, the enterprise need report this information only in a foreign versus domestic manner. In addition, the disaggregation of revenue, profitability, and identifiable assets data must be reconciled to the consolidated statement [SFAS 14, p. 153].

"Where's the flexibility?" Clara Peller (of the famous "Where's the beef?" commercial) might demand. Paragraph 34 of SFAS 14 stands out like a sore thumb or like a shining beacon, depending on one's opinion regarding flexibility in financial reporting. Paragraph 34 gives MNCs wide latitude in defining geographic areas. It states, in part:

> . . . foreign geographic areas are individual countries or groups of countries as may be determined to be appropriate in an enterprise's particular circumstances. No single method of grouping the countries in which an enterprise operates into the geographic areas can reflect all of the differences among international business environments. Each enterprise shall group its foreign operations on the basis of the differences that are most important in its particular circumstances [SFAS 14, p. 153].

Thus, groupings by geographic area are left to management judgment. This leads to a situation in which one enterprise can disclose by country, while a similar enterprise can report by hemisphere. To illustrate the MNC dilemma, an overview of the Marriott Corporation follows.

A Case Study: The Marriott Corporation

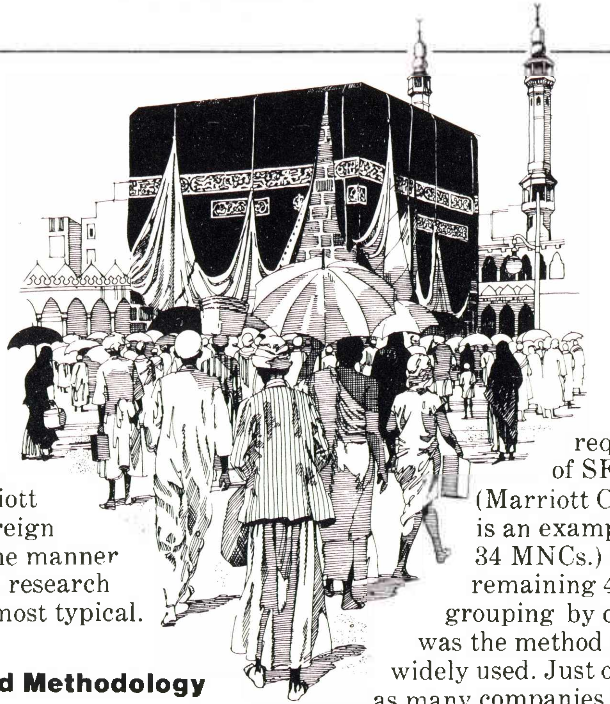
Marriott began as an A&W Root Beer stand in Washington, D.C., in 1927. Recognizing the seasonality of sales, J. Willard Marriott, Sr., soon expanded his enterprise with the addition of food. A&W objected to this addition and severed ties with Marriott. Marriott renamed his beer and food stands "The Hot Shoppe." Within a year, Marriott opened the first drive-in restaurant on the east coast. Ten years and many Hot Shoppes later, Marriott expanded into the then-new field of airline catering. In 1957, the Marriott Corporation acquired its first motel, which began operating as the Twin Bridges Marriott Motor Hotel in Arlington, Virginia.

> ***. . . several methods of geographic segmentation are employed.***

In 1966, Marriott Corporation embarked on its first international venture, an airline catering kitchen in Caracas, Venezuela. Marriott opened its first European hotel in Amsterdam in 1975. In 1982, Marriott acquired Host International, a corporation which owned airport retaurants and shops. Howard Johnson's was purchased in 1985. Over an average of nearly 20 years, Marriott Corporation sales have increased at about 20 percent per year [Kennedy, 1988].

Despite its size and the apparent health of its financial statements, Marriott has been rather tentative about foreign expansion (It was one of the last large lodging corporations to expand into the European market.) To date, its foreign revenues or assets have not met the 10% threshold to activate the disclosure requirement of SFAS 14. Thus, the disclosures presented are voluntary. The disclosures taken from Marriott's 1987 financial statement are representative of the geographic disclosures contained in the financial statements for 1983 through 1986. For example, sales of foreign subsidiaries and affiliates were $415.2 million in 1987, $286.1 million in 1986, and $213.1 million in 1985 while foreign income before income taxes was $19.6 million in 1987, $11.5 million in 1986, and $21.7 million in 1985 [Marriott Annual Report, 1987]. Prior to the 1987 financial statement, Marriott also disclosed foreign assets.

What is the incentive for Marriott to release this type of information? Perhaps the "signalling" theory provides an explanation. This theory is based on the premise that a corporation voluntarily discloses information in order to provide certain signals to the market [Penman, 1980]. These voluntary disclosures typically relay only good news. However, it is sometimes advantageous for a corporation to voluntarily disclose gloomy information in order to resist government intervention or a large wage hike demanded by labor. In Marriott's case, the disclosure is good news. Most investors are already aware that Marriott operates overseas; what they may not know is that foreign sales and foreign income are on the rise. Thus, Marriott is signalling



that its foreign operations and sales have been growing. Marriott disclosed its foreign operations in the manner revealed by the research findings to be most typical.

Research and Methodology

This research examined the various methods of geographical grouping used by MNCs. The National Automated Accounting Research System (NAARS), a computer library containing individual annual reports of over 4,000 firms, was used to pinpoint firms reporting by geographic segment. The search phrase "ftnt (segment w/20 geographic)" was used to search the annual reports for 1987. The search phrase asked NAARS to search within the footnotes and find each instance when the word "segment" was within twenty words of the word "geographic." The search returned 440 individual annual reports.

The footnote disclosure of each annual report was examined to determine how the geographic areas were segregated according to the following categories: domestic/foreign, hemisphere, continent, region (e.g., Far East), and country. In some cases, categorization was difficult because MNCs adopted more than one method of grouping. For example, a company might report sales, profitability, and identifiable assets for the U.S., Canada, Europe, and South America. In an instance such as this, the company was categorized as reporting primarily by continent.

Of the 440 annual reports examined, 34 reports were not usable due to insignificant foreign involvement (less than 10%) that exempted the companies from the reporting requirements of SFAS 14. (Marriott Corporation is an example of these 34 MNCs.) For the remaining 406 MNCs, grouping by continent was the method most widely used. Just over half as many companies chose to report by the domestic/foreign or the country categories. Reporting by region was infrequent, and reporting by hemisphere was rare.

The major limitation of this research is the difficulty in categorizing the geographic segmentation. Some companies used a mixture of reporting methods and, thus, could have been categorized in several different ways. When a company reported by country and continent, its categorization was based on which was the most prevalent (i.e., the number of countries versus the number of continents). The exception to this rule occurred when an MNC separated information for the U.S., Canada, and Europe. These MNCs were classified as reporting by continent, not by country. When the number of countries reported equalled the number of continents, the MNC was classified as reporting by continent rather than by country.

Another limitation involved the search phrase. It is possible that the search did not retrieve all of the instances of geographic segmentation in the NAARS file of 1987 annual reports. However, the search was sufficiently broad to capture a large representative sample. Thus, the results are not significantly biased.

Research Implications

In Statement of Financial Accounting Concepts Number 1, *Objectives of Financial Reporting by Business Enterprises*, the FASB maintains the following position on financial reporting:

> Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions — for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities [SFAC 1, p. 8].

However, do the provisions in SFAS 14 regarding the disclosure of foreign operations enable an investor to make a "reasoned choice"? It seems that they do not. Imagine a scenario in which the risks of overseas operations (e.g., expropriation, economic conditions, war, etc.) are being evaluated by an investor. If the companies being evaluated report by continent and have significant Asian operations,

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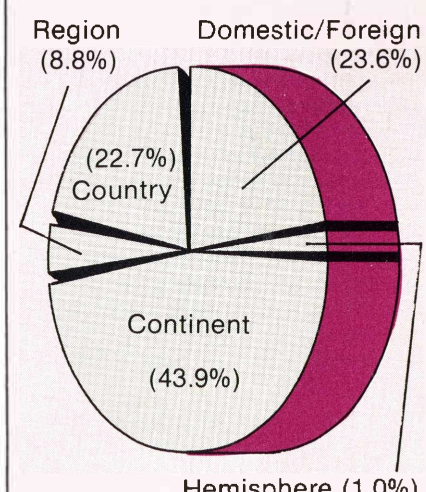
Geographic Segment Disclosure By Categories 1987 n = 406



. . . groupings by geographic area are left to management judgment.

the investor is unable to tell whether the operations are in a stable country such as Japan or in a volatile environment such as Vietnam or Cambodia. Thus, a "reasoned choice" on the basis of foreign operations disclosure is limited by the flexibility allowed by SFAS 14.

Is it necessary for FASB to reduce this flexibility? After all, if one presumes that the market is efficient then ". . . corporations will be motivated to upgrade their financial disclosure in order to obtain scarce money capital as cheaply as possible" [Choi, 1979, p. 159]. However, the research results show that corporations have not been motivated to clearly indicate market risk concerning foreign operations. In the absence of this motivation, the FASB needs to strengthen the reporting requirements. A workable alternative to current SFAS 14 geographic segment requirements would be to require MNCs to segment information according to country. For MNCs operating in a large number of countires, the disaggregation could be limited to ten countries, similar to the treatment for line-of-business (LOB) disclosures. Disclosure by country better enables the investor to assess risk.

Additionally, for personal and moral reasons, certain investors might prefer not to invest in companies that do business in certain countries, such as in South Africa. Since SFAS 14 allows latitude in geogrphic reporting, the MNC might disclose only that business is conducted in Africa. The investor then has three choices: to investigate further, checking other sources to determine whether the enterprise is conducting business in South Africa; to invest and hope the enterprise is not involved in South Africa; or to choose not to invest in any company that reports that it does business in Africa. The FASB does not address this issue in considering the objectives of financial reporting, but perhaps it should. In the area of social disclosure, the U.S. lags behind the industrialized Western European countries (most notably West Germany).

A workable alternative to current SFAS 14 geographic segment requirements would be to require MNCs to segment information according to country.

Extensions of Research

Further research could be done to determine whether some pattern in geographic segment reporting has developed. For example, five years could be studied to see whether companies are switching from reporting by country to reporting by continent or vice versa.

In addition, a researcher could determine whether common characteristics exist among MNCs that use the same geographic segmentation method. Perhaps these common characteristics lead an MNC to choose a particular grouping method.

Lastly, studies done on the requirements for LOB segmentation suggest further research opportunities in the area of geographic disclosure. In 1979, Collins and Simonds showed a downward trend in market risk (beta) after the SEC LOB requirement became effective. Baldwin [1984] explored the effect of LOB disclosure on the ability of security analysts to predict earnings per share (EPS). Twombly empirically tested the hypothesis "that disclosures by firms whose markets had different levels of concentration would have different implications for the distribution functions of returns assessed by capital market agents" [1979, p. 77]. He found that the Federal Trade Commission requirements for LOB segmentation "provided no unanticipated information to the capital market" [1979, p. 77]. To date, no one has empirically studied geographic disclosure and its effect on market risk or EPS.

Conclusion

SFAS 14 allows great latitude in the grouping of geographic areas. The question remains whether this latitude renders the information useless. Evaluation of risk is difficult when a corporation reports by continent, the most popular method of grouping according to this research. In the current

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climate of increasing multinational involvement, it may be time for FASB to examine SFAS 14 as it pertains to foreign operations and reduce some of the flexibility.

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Nonbusiness Organizations

Request For Articles

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The purpose of the non-business column is to provide readers with practical and theoretical information relevant to not-for-profit entities and state and local governments.

Currently, the question of whom is the primary standard setter of GAAP for non-business is a subject of interest. Other topics attracting attention are the single-audit act, the related SASs, arbitrage rebate rules for tax-exempt bonds, the Measurement Focus and Basis of Accounting — Governmental Funds and the changes associated with it, GAGAS, and pension accounting, to name a few.

I welcome your articles sharing your experience and ideas relevant to this area of accounting. Manuscripts should be four to six pages long, double-spaced and typed.