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Challenges in international auditing

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Only the American and British accounting firms extend their practice to foreign soil to any great degree. This paper will relate primarily to the Americans, although there are many problems common to both American and British firms practicing on a world-wide basis. Differences in tax laws and legal systems in general, language barriers, different currencies, finding and training personnel, strong nationalistic feelings in many countries, differences in accounting principles and auditing standards, are illustrations of some of the common problems.

You might logically ask why auditors undertake to practice in a foreign country in the first place. The answer is that the accounting profession of any community exists because of the needs of business of that community for accounting and auditing services, and the accountant must be in a position to look after the needs of his client wherever in the world the client chooses to establish operations. You might also logically ask why it is not feasible for the accounting profession in any given country to attend to the accounting needs of any business operating there, whether foreign-owned or not. The answer is that when American capital (and British capital) began to go abroad shortly after the turn of the century, the accounting profession in most foreign countries had not developed to the point of being able to render proper services; this is still true of many countries today. Perhaps the overriding reason for the extensive international practice of American accounting firms is the attitude of American boards of directors who wish to look to one firm as having over-all responsibility for the entire engagement.

Naturally it will not be possible to go into the full range of problems the American firm encounters abroad, but I shall treat a representative few that I trust will interest you.

DIFFERENCES IN ACCOUNTING PRACTICES

The increasing volume of international investment, credit, and trade has resulted in increased attention to ways and means of achieving some desirable uniformity in international accounting practice. Regardless of the desirability of some international uniformity, we at this moment must face the realities: There *are* differences in accounting practices, and this is the area which I shall briefly describe.

Revaluation of Property

Up to the present time, the revaluation of property in the United States is not generally accepted as proper accounting, although it has some advocates in the accounting profession and the business community. Revaluation of property has become accepted practice in many Latin American countries, such as Argentina, Brazil, Chile, and Panama. In other countries, such as Mexico, Germany and, to a certain extent, Canada, revaluation is permitted or accepted but is not very widely applied. It is accepted practice in Japan and common in France and Italy. To the best of my knowledge, Australia, Great Britain, and the Republic of South Africa accept the theory, but write-ups are generally made only in connection with reorganizations. From these few examples, we see that there are many and varied viewpoints concerning the revaluation of property throughout the world.

Depreciation

In practically all countries mentioned where revaluation of property is accepted practice, depreciation is based on the restated property accounts for financial statement purposes and is an allowable deduction in determining taxable income. There are a few other differences between depreciation practices in some foreign countries and in the United States. In the Netherlands, for example, depreciation is provided on construction work in progress and it is considered permissible to continue to provide depreciation on fully depreciated assets. In Brazil, depreciation is not always provided on buildings because it is not deductible for tax purposes. In Japan, in addition to normal depreciation, companies may set up arbitrary additional amounts when such amounts are allowable deductions for income tax purposes. It seems that tax law has a significant influence on depreciation policy in many countries.

Secret Reserves

The European businessman, and businessmen in some other parts of the world, believes very strongly that it is good business to set aside a part of profits in a good year for use in bolstering profits in a bad year, with the concurrence of the accounting profession in those countries. They cannot understand why the American businessman does not do the same thing.

Without doubt, inventories present the most fertile area for creating secret reserves. Except for the fact that LIFO is rarely used in other countries, there appears to be no major difference in the method of valuation of inventories between the United States and most other countries;

the lower of cost or market is generally used. However, most European businessmen are quite ingenious when it comes to finding ways and means of writing down perfectly good inventories. Furthermore, several countries have permitted inventory reserves for income tax purposes.

In addition to the undervaluation of inventories, secret reserves are created by the arbitrary write-down of other assets, the unnecessary accrual of liabilities, and the creation of unneeded general reserves.

Accrual of Liability for Income Taxes

In a few countries, it is the practice to record income taxes when paid rather than to accrue them in the year in which the related income is earned. Brazil, Italy, Japan, and Switzerland follow this practice.

Stock Dividends

There are also differences in accounting for stock dividends between the United States and other countries. They exist with respect to both the issuing corporation and the recipient stockholder. First as to the issuing corporation: Under a Bulletin issued by the American Institute of Certified Public Accountants' Committee on Accounting Procedure in 1952, the issuing corporation should transfer from earned surplus to the category of permanent capitalization (capital stock and capital surplus) an amount equal to the fair value of the shares issued. There is still much difference of opinion in the accounting profession about the views expressed in that Bulletin. The United States stands almost alone in thus accounting for a stock dividend. Most other countries, either because of requirements of law or because of common practice, require only that the par value of the shares be transferred to capital stock, and in many countries the offsetting charge can be made to earned surplus or to capital surplus arising from any source.

As to the recipient of a stock dividend, the aforementioned Bulletin takes the position that the stockholder has precisely the same interest in the issuing corporation as he had before the stock dividend was received and that he has realized no income. In many countries of the world, however, a stock dividend is regarded as income to the recipient; he is required to record it as income and pay taxes on it.

Charges to Earned Surplus

In many foreign countries there is no such account as "earned surplus" although a "profit and loss" account seems to have about the same general purpose. Furthermore, there does not appear to be as clear a distinction between income and surplus (or profit and loss) as in the United States. I have read reports, for instance, where such items as directors' fees, officers' bonuses, etc., are shown as charges to the equivalent of earned surplus. Such items are not accrued at the end of the year to which they pertain since there is no legal liability and no authority to record them, until they actually have been approved by the stockholders; and the stockholders do not meet until after the annual accounts are closed. Since these items are applicable to a prior year they are therefore charged to the "profit and loss" account when paid. In a few countries, such items are regarded in the same way as dividends—a distribution of profits. Also, I have observed a few instances where provision for bad debts is consistently charged to the "profit and loss" account. Thus, items normally considered ordinary operating expenses in the United States are never charged to operating expenses in some countries.

There are of course other differences between accounting practices in the United States and other countries but I have mentioned the more important ones. The existence of these fundamental differences naturally suggests the problem of properly bringing them to the attention of the reader of financial statements.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The standard opinion used for many years by American CPAs states that the financial statements present fairly the financial position and results of operations of the company "in conformity with generally accepted accounting principles." This phrase originated in the United States and originally it was our view that any accountant using this expression in his opinion was referring to accounting principles in the United States. This view is no longer tenable because the same expression now appears in opinions in Canada and in a number of Latin American countries. An expression roughly comparable is also found in the opinion of the Japanese CPA. Accountants of still other countries may be using comparable language as well.

There is now the possibility that an informed reader of a report may be confused or even misled by the phrase "generally accepted accounting principles", unless there is proper disclosure of the basis of those principles. For instance, suppose a Canadian corporation with United States stockholders decides to appraise its properties and restate its accounts to reflect such appraisal. Since this is acceptable accounting practice in Canada, the Canadian accountant's opinion on the financial statements would use the expression "in conformity with generally accepted accounting principles." Unless there were full disclosure in the financial statements or notes thereto, the American stockholder might believe that the accounting principles are the same as those in the United States, or he might even get the impression that accounting principles are the same the world over.

As you probably know, the International Finance Corporation, a sister organization of the International Bank for Reconstruction and Development (World Bank) makes investments and loans all over the world. Recently the IFC issued guidelines for accountants examining the financial statements of companies in which it has an interest. I understand that when the matter of suggesting the phrasing of the accountants' opinion was considered, the IFC wished to have it contain the statement that the financial statements presented fairly the financial position, etc., "in conformity with generally accepted accounting principles." At this point it was recognized that the use of this phrase created a problem since it has different meanings in different countries of the world. I believe that there would be many cases where if this wording were used without some clarification, the IFC might will be misled.

Our own Firm holds this view: Good reporting requires whatever modification of standard phraseology is necessary to provide the American reader with an intelligent report. He must be informed wherein the accounting principles applied in the financial statements differ from principles normally followed in the United States. The opinion our Firm rendered on a Japanese company that filed a Registration Statement with the SEC last year will illustrate our method of dealing with a situation where there was a difference in accounting principles. This opinion reads as follows:

"In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the financial position of the Company at November 30, 1962 and the results of its operations for the periods stated, in conformity with generally accepted accounting principles, which in Japan comprehend revaluation of properties as described in Note 2 to the Financial Statements, applied on a consistent basis."

Note 2 describes the circumstances in Japan, because of which companies have been permitted by law to give accounting recognition to some extent to the loss in the purchasing power of the yen by revaluing certain of their properties upward and computing depreciation for income-tax purposes, and in the case of our client for rate-making purposes, on the higher amounts.

The wording of our opinion, together with the footnote disclosure in the financial statements, clearly informs the American reader wherein the accounting principles applied in the financial statements of this Japanese company differ from principles normally followed in the United States.

FINANCIAL STATEMENTS IN COUNTRIES SUFFERING SEVERE INFLATION

Except for the occasional revaluation of property, the effect of inflation ordinarily is not shown in the financial statements of foreign corporations. However, for companies operating in countries experiencing severe inflation (such as Brazil and Chile), I believe that financial statements expressed on a price-level basis, giving effect to the decline in the purchasing power of the local currency, are in the circumstances more meaningful and are compatible with generally accepted accounting principles. The amounts shown in such financial statements are developed by applying a general price-level index to the historical amounts.

That such statements are more meaningful under extreme inflationary conditions, I believe few will question. However, some may question the view that they are compatible with generally accepted accounting principles. Therefore, I shall mention briefly some of my reasons for believing this to be true. First, the primary purpose of generally accepted accounting principles is to provide criteria for fair presentation. A basis of presentation clearly accomplishing this purpose more effectively is, I believe, inherently compatible; conversely, it is inconceivable to me that generally accepted accounting principles could be interpreted to inhibit fair presentation. Second, the statutes and accounting practices of many countries recognize price-level adjustments of property, depreciation, inventories, and certain other accounts. Third, certain statements in official accounting literature in the United States imply that price-level statements are not incompatible with generally accepted accounting principles. For example, Chapter 9 of Accounting Research Bulletin No. 43 states that: "Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries."

A few highlights from the financial statements recently issued by a Brazilian client of our Firm might be mentioned. They show clearly the impact of inflation and the contrast with statements presented on an historical basis. This client's plant was built principally in 1958 and 1959. The degree of inflation that has permeated the Brazilian economy since that time is indicated by the general price index used in preparing these statements. Here are the figures: 1958—229, 1959—316, 1960—407, 1961—559, 1962—848, 1963—1465. These indexes are annual averages;

by December 1963 the index had risen to 1872. The net effect of such inflation is indicated by the fact that the client's financial statements for 1963 showed a net *income* of 145 million cruzeiros on the historical basis as contrasted with a net *loss* of 540 million cruzeiros on a price-level basis. A further interesting and sobering factor disclosed by these statements is that a substantial provision for income taxes was required because the tax laws do not give adequate recognition to the impact of inflation.

Our opinion on these statements is another interesting feature of this report. Insofar as I know, this report is the first one in which a United States-affiliated firm has expressed an opinion that financial statements presented on a price-level basis are in conformity with generally accepted accounting principles. I believe The Netherlands firm of Klynveld, Kraayenhof & Co. has issued such an opinion on the statements of Philips Industries; and I think one or more United States firms have issued opinions in which the historical-basis statements have been said to be in conformity with generally accepted accounting principles and in which a supplementary opinion has been expressed with respect to the price-level statements.

AUDITING STANDARDS

The American firms generally have no problems with respect to auditing standards since they apply auditing standards of the United States, as required by the American Institute of Certified Public Accountants. Because of the type of accounting records or local business practice, auditing procedures and techniques may differ at times from those employed in the United States. For instance, in most Latin American countries and in a number of European countries, canceled checks are considered to be the property of the bank and are not returned with the bank statements. Procedures for reconcilement of bank accounts, and for verification of disbursements, therefore must be altered, but the standards remain the same.

In England and most European countries, auditing procedures differ in two important respects from those in the United States, namely, observation of physical inventory-taking and confirmation of accounts receivable. A number of the large Japanese companies have recently sold securities in the European money market. One of these companies inquired of our Tokyo office about whether United States or European auditing standards and procedures would be applied if that office should be engaged to conduct the audit. The answer was that United States auditing standards and procedures would be applied. In fact, United States auditing standards are applied in all our international engagements, regardless of jurisdiction.

TRAINING OF PERSONNEL

The international practice offices of American accounting firms have certain unusual problems in the employment and training of personnel. Apart from differences of language and commercial customs of many countries, there are restrictions on bringing in foreigners to staff practice offices. Many countries require that a certain percentage of the staff be nationals of the country in which the practice office is located. Many of these nationals are already trained in the accounting and auditing procedures of their own country, but it is also necessary for them to be instructed in the accounting and auditing procedures generally accepted in the United States. This situation is usually met through special training courses, which often have to be conducted on a bilingual basis. Furthermore, our Firm's standard procedures with regard to audit working papers and programs have to be thoroughly understood by all our staff accountants.

As a general rule, the programs and working papers of our international practice offices are in English. Generally, this fact does not cause any great inconvenience, since English for all practical purposes has now become the commercial language of most of Africa and Asia and is a second language in Europe and Latin America.

In addition to the staff training programs conducted for all employees in our international practice offices, certain staff members from those offices are selected for intensive training in this country. The Secretary of State in Washington has designated our Firm to participate in an Exchange Visitor Program under which we may bring a number of trainees to our practice offices in the United States for periods of up to eighteen months. After that time they must return to their country of domicile.

The ability of an American accounting firm to offer adequate services to its clients abroad is only obtained after years of effort and training. The operation of a practice office abroad, it is probably correct to say, requires considerably more "know-how" than would be needed for a similar practice office in the United States. Unfortunately, this circumstance is not widely appreciated within the accounting profession or among its clients.

CONCLUSION

This paper has given you, I hope, a general idea of the many problems encountered in practicing abroad as we have found them in our experience.

Our international practice offices have frequently had to cope with incidents that would be unheard of in the United States, but since most of these situations arise from local conditions or incomplete understanding of the viewpoint of others, usually it is not too difficult to resolve them by informal discussion.

Our most important problem abroad is perhaps a permanent one. I would describe it as the necessity for our international offices to conform to United States standards. This makes it essential that any material deviation from these standards shall always be clearly disclosed in the reports issued by our international practice offices.