

# Research Issues in Accounting for Cross-Border Organizations<sup>1</sup>

Shyam Sunder

Yale University

(Slide 1)

(Slide 2). We can think about the problems of financial reporting and control in cross-border organizations at the level of individual organizations; as well as at more aggregate, economy-wide, levels. Economies can be viewed at national, regional and international levels. If time permits, we shall consider a third level and analyze the problems faced by individual agents in making decisions in cross-border settings. What are some of the interesting research issues in these areas? Since I have the task of merely identifying the issues, without having to address them myself, perhaps I can afford to be more expansive than those who actually have to find the answers.

## **Organizations and Accounting**

Instead of starting at the top or the bottom of my list, allow me consider the organizations first, and then link them to the more aggregate, and if we have time, to the individual decision levels. (Slide 3) We can think of business organization as a set of contracts, and accounting as a mechanism to define, implement, and enforce these contracts. The contracting parties supply various factors of production to the firm, and buy its output. These contracts depend on the factor and product market conditions, and therefore vary across individuals, organizations and economies (Sunder, 1997). The contract model of the firm and accounting can serve as a theoretical basis for cross-border

---

<sup>1</sup> Presented at Conference on Cross-Border Business Combinations and Strategic Alliances, Berlin, June 22-25, 2001.

comparisons in accounting practices. Such cross-border comparisons, in turn, can provide tests of the contract theory.

If organization consists of contracts among a variety of agents, the relationship with various agents is mediated through a variety of markets (Slide 4). The best known of these markets are for labor, both managerial as well as other, financial capital, both equity and debt; and for products and services bought and sold for a price. For the sake of completeness we could add public services we “buy” from government bodies in exchange for taxes we pay.

(Slide 5) To function and survive, organizations create a mechanism to help define, implement, and renegotiate all these contracts for labor, capital, products and services. Accounting is a crucial element of this mechanism. Forms and details of the contracts depend on the conditions prevailing in these markets. Cross-border combinations and alliances face the special problem of having to deal with market conditions on both sides of the border. Let us briefly review some examples of differences in “same” markets across borders.

### **Cross-Border Market Comparisons**

(Slide 6) Markets for labor, financial and physical capital and information do not exist in all societies. Even when they do, they are not always in the same stage of development. Accounting and control systems depend on the degree of market development in the relevant societies. Since cross-border alliances may involve markets in different stages of development, novel accounting problems arise in dealing with such entities. Consider a few examples.

### *Labor Markets*

(Slide 7) Managers accumulate skill capital on the job. Some skills are job or company specific, while others are transferable to other jobs, organizations, or industries. Entry-level cash compensation is lower, not only because such managers are less skilled but also because a good part of their compensation is in the form of an opportunity to enhance their human capital.

The extent of development of markets for human skills varies greatly across countries, even among industrialized countries. Opportunities to build human capital on the job, cost of finding and switching jobs (including seniority and retirement benefits), and the ability to move and live geographically away from home are some of the factors that determine the extent of development of labor markets. In cross-border alliances, these labor market differences present some of the thorniest problems in measurement of performance and establishing control. In one country employees may have civil-service style seniority wages and job security (e.g., for *hontai* workforce in Japan) while in the other country firms may use compensation based on measured performance, and provide little security to non-performers. Low labor market search costs may also allow firms to layoff employees more easily than in others. Depending on the development of the markets for financial capital, to be discussed shortly, some countries may make significant use of equity shares and options in defining the compensation schemes for their managers and other employees, while others may refrain from doing so. Finally, employee expectations of behavior of others are formed largely by observation and experience, and may differ considerably across countries. These differences are also

called culture. When employees move across borders, they may see things they do not expect, and suffer “culture shock.”

(Slide 8) Labor market conditions and labor contracts determine the degree of risk borne by employees. Employee risk bearing can take at least four different forms and vary significantly across countries. First, employees may also hold shares in the firm, forcing them to consider the effect of wage demands on the value of their equity. Second, there are vast differences across borders in funding of employee pension plans; unfunded pension plans force the employees to share the risk of failure of the firm during their retirement years. Third, labor contracts may transfer a part of the risk to employees by allowing downward adjustment of compensation and working conditions in business downturns; or may link a part of compensation explicitly to profitability of the business through bonus plans.

(Slide 9) It would be easy to avoid these problems in cross-border alliances by keeping employees in their own countries. However, the alliance may also forfeit most of the synergies its constituents may have hoped to reap from cooperation in the first place. This raises the first set of research issues: What is the relationship between labor market development and measurement of performance and compensation in various countries? What can cross-border organizations do to handle such differences in countries they operate in? How must the accounting systems be modified to be robust against manipulation in performance-based compensation environments? Strong pay performance links (see Cyert et al., 1995; Shah, 1996) in U.S. managerial contracts make demands on U.S. accounting systems that are largely absent in seniority based systems. How do we align the expectations of employees when they move from one environment

to another? What is the role of employee risk bearing in performance measurement and control?

### *Markets for Financial Capital*

(Slide 10) A great deal of demand for financial reports originates in the markets for financial capital including equity, bonds, bank loans and mortgages. Though financial capital is the most liquid and homogenous of all resources, organization and development of these markets still differs considerably across countries. These differences cause financial reporting to vary across jurisdictions, and place special demands on reporting by cross-border organizations. Let me illustrate this by comparing the markets for corporate debt capital in U.S. and Japan (see Sunder, 1999, for more details).

(Slide 11) In the United States, borrowing firms shop around for the best terms; banks are reluctant to provide credit to a borrower in serious trouble; firms can make prepayments on their loan, and vary the amount of credit according to their needs, maintaining only a relatively small level of compensating balances. (Slide 12) In Japan, lending banks often own significant equity of their creditors. The amount of credit is more stable over time, with some features of equity. Firms maintain higher compensating balances raising the effective rates of interest. The banks assist the company in difficult circumstances. There is little term financing, with most credit consisting of three-or four-month fixed interest discounted notes that may be rolled over through informal agreements. While the interest rates have been deregulated in recent years, for a good part of the postwar half-a-century, the interest rates remained regulated. Banks did not compete on interest rates. The bank-borrower relationship is of a longer

term and open-ended nature. Corporate bonds are not common, and are secured by fixed assets when used. Secured lenders have little interest in the financial statements of the borrower as long as they know that the assets used to secure the bonds exist and are well maintained.

Given a different contractual relationship between lenders and borrowers, and the accounting and control system needed to implement and enforce this relationship is also different. In Japanese and German corporations, representatives of banks often sit on the board of directors of Japanese and German firms, and they need not depend on published financial statements to gather information about their debtors. Less emphasis on detailed financial standards for preparation of financial reports in Japan is, in part, a result of the differences between how the markets for financial capital are organized.

After 1976, the Bank of Japan's primary policy objective shifted from growth to inflation control, and from directly controlling the volume of bank lending to reliance on market rates of interest for allocating funds in the industry. Change in fund allocation policy may have induced changes in the information and accounting systems. As the main bank relationships began to weaken in the 1980's, Japanese accounting also began to move in the direction of U.S.-style, equity-based criterion for consolidation of financial statements.

(Slide 13) This brief consideration of markets for financial capital raises two research questions. How well do the financial reports currently prepared in various countries serve the markets for financial capital in those countries? Most countries feel a tremendous pressure for change in financial reporting today. I would like to know if this pressure is retrospective—an attempt to make up the deficiencies of the financial

reporting system relative to the prevailing market conditions, or is it prospective—an attempt to prepare for the future?

### *Industrial Organization*

(Slide 14) Interrelationships among U.S. firms are relatively weak except for parent-subsidiary firms related through equity ownership. In the United States we look primarily at the equity ownership to choose among consolidation, equity method, or lower-of-cost-or-market. In Japan, on the other hand, there exist two types of groups of business firms. *Ex-zaibatsu* or horizontal groups of firms are related primarily by equity interest held by a main bank in all members of the group. *Keiretsu* are groups of industrial companies that are linked together not only by mutual equity holdings but, more importantly, by operational arrangements within the group such as customer-supplier-distributor relationships.

The hierarchical structure of corporate groups in the United States stands in sharp contrast to the nonhierarchical character of the Japanese corporate groups. The equity criterion that serves reasonably well for developing the group financial statements in the United States does not yield useful results in the Japanese environment (Kajiwara 1999). While the Japanese, for the time being, do use the U.S. criteria for consolidation, the result is a square peg in a round hole. To the extent that the corporate groups in the two economies are organized by different criteria, no one single criterion can yield results free from difficulties of comparisons across the two economies. An interesting research question is: what can accountants do to increase the effectiveness of accounting rules across the globe populated with economies with structural differences?

(Slide 15) To summarize: design of contracts that define firms, and therefore their accounting systems, depend on the conditions in the firms' factor and product markets. A comparison of market conditions across countries is a good starting point for understanding, perhaps even predicting, cross-border differences. Neither the market conditions nor the financial reporting standards and practices are static. It would be difficult to defend the current reporting practices in any country to be optimal, relative to the current or anticipated future market conditions. Even as the financial reporting practices and standards adjust to accommodate these changes, it is useful to keep in mind the basic reasons for their differences; and the limitations of harmonization in a world that is, and will likely remain, diverse in many respects for years to come. Instead of making a premature commitment to a single set of worldwide standards, there may be value to allowing alternative sets of standards to compete in the marketplace (Dye and Sunder, 2001).

(Slide 16) One possible way to help various economies move toward standards, which may be more efficient relative to their own respective economies, is to encourage each country to permit open competition between two sets of accounting standards. One of these sets could consist of locally developed standards which best suit the local conditions. A second set could be standards developed outside the country, such as those developed by the International Accounting Standards Board or by another country (e.g., the FASB). Each firm within the country could freely choose one of the two sets of standards for its financial reports, and clearly mark the reports with this choice.

(Slide 17) Under this system of competitive standards, a firm could choose the standard, which it believes will best serve its interests—presumably lowering its cost of

capital. If the investors agree with the firm's choice, it would be the best of both worlds. If the investors disagree, they will lower the price of the securities of the firm, raising its cost of capital, forcing the firm to review its choice of accounting standards.

This competitive mechanism will also induce the local standard setting body to carefully balance the special conditions that prevail locally against the larger, perhaps global, considerations. If the differences in local conditions are important enough, local standards can differ from standards used elsewhere. However, the ultimate judgment about this "sufficiency" will be made by the investors in the security markets when they determine the price, and not by arguments in a committee room. (Slide 18) This dual standards mechanism will introduce international practices locally at a speed best suited for the local economy. It will also help cross-border organizations by allowing them a choice between local or imported practices.

This is a market-based solution to the problem of international harmonization of cross-border financial reporting standards. My final research questions are: Why have we depended on monopoly standards for so long? Will regulatory competition do better?

## Bibliography

- Alford, Andrew, Jennifer Jones, Richard Leftwich, and Mark Zmijewski. 1993. "The Relative Informativeness of Accounting Disclosures in Different Countries," *Journal of Accounting Research* 31 (Supplement), 183-223.
- Amir, Eli, Trevor S. Harris, and Elizabeth K. Venuti, 1993, "A Comparison of the Value-Relevance of U.S. versus Non-U.S. GAAP Accounting Measures Using Form 20-F Reconciliations," *Journal of Accounting Research* 31 (Supplement), 230-264.
- Aoki, Masahiko, ed. 1984. The Economic Analysis of the Japanese Firm. New York: North Holland.
- Choi, Frederick D.S., and Gerhard G. Mueller. 1993. Globalization of Financial Accounting and Reporting. Morristown, NJ: Financial Executives Research Foundation.
- Cyert, Richard M., Sok-Hyon Kang, Jinbae Kim, and Praveen Kumar. 1995. "Agency and Performance Pay: Theoretical and Empirical Analysis," Graduate School of Industrial Administration Working Paper, July.
- Dye, Ronald A., and Shyam Sunder. 2001. "Why Not Let the FASB and IASB Standards Compete in the U.S.?" Accounting Horizons (Forthcoming, September 2001).
- Fukui, Yoshitaka. 1998. Three Essays on Accounting and Reality, Chapter 3. Ph.D. dissertation. Carnegie Mellon University.
- Harris, Trevor S. 1995. International Accounting Standards versus U.S.-GAAP Reporting: Empirical Evidence Based on Case Studies. Cincinnati, OH: South-Western College.
- Jacobson, Robert, and David Aaker. 1993. "Myopic Management Behavior with Efficient, but Imperfect Financial Markets: A Comparison of Information Asymmetries in the U.S. and Japan," *Journal of Accounting and Economics* 16:4, (October 1993), pp. 383-406.
- Kajiwara, Akira. 1999. "The Functions of Consolidated Financial Statements in Japan," in Shyam Sunder and Hidetoshi Yamaji, eds. The Japanese Style of Business Accounting. Westport, CT: Greenwood Publishing.
- Mak, James, Shyam Sunder, Shigeyuki Abe, and Kazuhiro Igawa, eds. 1998. Japan: Why It Works, Why It Doesn't; Economics in Everyday Life. Honolulu, Hawaii: University of Hawaii Press.
- Nobes, Christopher. 1991. Accounting and Financial Reporting in Japan. 2<sup>nd</sup> ed., Dublin, Ireland: Lafferty Publications Ltd.
- Pownell, Grace. 1993. "Discussion of the Relative Informativeness of Accounting Disclosures in Different Countries," *Journal of Accounting Research* 31 (Supplement), 224-229.
- Shah, Anish. 1996. "Organizational Performance and Executive Compensation: Directors' Incentives, Product Market Share and Components of Pay." Ph.D. dissertation. Carnegie Mellon University.
- Sunder, Shyam. 1988. Political Economy of Accounting Standards," *Journal of Accounting Literature*, 7, 31-41.
- Sunder, Shyam. 1997, Theory of Accounting and Control. Cincinnati, OH: Southwestern.
- Sunder, Shyam, 1999. "Design and Implementation of Contracts: A Comparison of Factor Markets Relevant to Financial Reporting in Japan and the U.S." in Shyam Sunder

and Hidetoshi Yamaji, eds., The Japanese Style of Business Accounting, Westport  
CT: Greenwood Publishing.

Shyam Sunder and Hidetoshi Yamaji, eds. The Japanese Style of Business Accounting.  
Westport, CT: Greenwood Publishing.