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# Class #22

# International Financial Analysis

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# Next Steps for Projects

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- **Analyst Project Presentations**
  - In Class on May 12 and 14
  - Same Format as previous presentations (should be no longer than 8 minutes!)
  - Due Diligence Presentations – (4-5 minutes in length)
  - **Presentation Schedule is Posted in Announcements**
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# International Financial Analysis and Valuation

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- Differences in Accounting Across Countries
  - Outsider versus Insider Economies
    - Legal Tradition and Law Enforcement
  - Observed Differences in Accounting Across Countries
- Differences in Opacity and Cost of Capital Across Countries

# Framework for Analyzing Accounting Across Countries

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- Financial reports for firms from different countries are often very different from each other. WHY?
- See attached tables describing properties of accounting earnings across countries
  - From Leuz, Nanda and Wysocki (2001)



# Accounting in Insider (Code-Law) Countries

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- Insider Economies (Codified System)
  - Legal system/accounting rules typically codified by government ministries
  - Close interplay between government & “major” constituents (large firms, banks, labor unions)
    - Capital supplied by large banks and other big investors.
  - Governing boards of firms include banks, labor unions and major suppliers/customers.
  - Transactions rely less on public information in financial reports.

# Accounting in Insider Countries

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- Insider Economies (Codified System)
  - Continental European Origin
    - Belgium, Denmark, France, Germany, Italy, Norway, Spain, and Sweden.
  - Japan: German commercial code & French accounting code adopted in (1800's)
- Result:
  - Public disclosure has smaller role in accounting reports and rules.
    - Dominance of private communication
    - Fewer publicly-traded companies in these countries / Fewer small outside investors

# Accounting in Outsider (Common-Law) Countries

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- Common Law System (Anglo-American)
  - Evolves from bottom up (vs top down)
    - Dispersed parties involved in “arms-length” transactions
  - Final arbiter is often the court system:
  - Financial reports try to present a “True & Fair” picture of firm performance.
  - Financial disclosures are more detailed.
  - Generally former UK colonies
    - UK, United States, Canada, Australia, New Zealand.
  - Because of trend toward greater litigation in the U.S., the financial reports of U.S. companies have become far more conservative.

# Implications of Poor Disclosure and “Opaque” Financial Reports

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- What happens if outside investors cannot decipher a company’s financial report?
  - Who bears the costs? What are the costs?
  - PriceWaterhouse Coopers Survey of Corporate Opacity:
    - The O-Factor
    - $O_i$  = average of (corruption, judicial and legal rights, economic opacity, accounting and governance opacity, regulatory opacity)

# Some Differences in Accounting Across Countries

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- **Accounting Rules in many countries allow for “Hidden Reserves”**
  - DEFINITION: An amount by which a firm has understated *Shareholders’ Equity* in a given year. The understatement arises from an undervaluation of assets or an overvaluation of liabilities. By undervaluing the net assets on this year’s balance sheet, the firm can overstate net income in the future by disposing of the asset.
  - Why is this allowed in some countries?
  - What is this entry called under U.S. GAAP and law?

# Big Differences in Accounting Even in “Similar” Countries

	<b>USA</b>	<b>United Kingdom</b>
Asset Revaluations	Since 1934, cannot revalue assets upwards (writedowns allowed)	Revaluations allowed. Professional appraisers assess value of assets
Accounting for Goodwill	Purchased goodwill not amortized (check for impairment)	Purchased goodwill either immediately write off or amortize
LIFO for Inventories	Allowed (must be same for IRS report)	Not allowed
Intangible Assets	Only purchased intangibles recognized	All intangibles valued – Use DCF or royalty method (appraisers)

# Differences in Accounting: Solutions

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- Investors & analysts need information that is consistent across companies – COMPARISON
- Diversity of accounting rules makes it difficult to compare companies across countries
- Potential Solutions:
  - Convenience Report: use local GAAP but print the report in language of users
  - Create 2 sets of reports under different standards (20-F reconciliation)
  - Use International Standards or adopt U.S. GAAP

# Differences in Accounting: Solutions

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- American Depository Receipts:
  - An American Depositary Share ("ADS") is a U.S. dollar denominated form of equity ownership in a non-U.S. company.
  - Represents the foreign shares of the company held on deposit by a custodian bank in the company's home country and carries the corporate and economic rights of the foreign shares, subject to the terms specified on the ADR certificate.
  - An American Depositary Receipt ("ADR") is a physical certificate evidencing ownership in one or several ADSs. The terms ADR and ADS are often used interchangeably.
  - Each ADR is backed by a specific # or fraction of shares in the non-U.S. company. The relationship between the # of ADRs and the # for foreign shares is called the ADR ratio.

# Types of ADRs

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	Expand Existing Shareholder Base		Raising Capital with ADRs		
	<i>Level I</i>	<i>Level II</i>	<i>Level III public offer</i>	<i>Private placement</i>	<i>GDR (global)</i>
<i>Description</i>	Unlisted in the U.S.	Listed on US exchange	Shares offered & listed in US	Placement with Institutions	Global offering
<i>Trading</i>	OTC	Amex, NYSE, Nasdaq	Amex, NYSE, Nasdaq	Private Placement Market	U.S. and non-U.S. exchanges
<i>U.S. reporting rules</i>	Exempt	Form 20-F reconcile to US GAAP	Form 20-F reconcile to US GAAP	Exempt	Varies

# Daimler-Benz Case

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- Daimler Benz filing with the U.S. SEC in 1993:
  - As a condition for listing on the NYSE, Daimler Benz had to meet the SEC's requirements of reconciling its accounts to US GAAP.
  - Net income based on German GAAP was DM 615 million.
  - Based on US GAAP, it had a loss of DM 1,839 million.
- Given the “embarrassingly” large difference, why did Daimler Benz accept to reveal this information in the US GAAP reconciliation?

# International Standards

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- The International Accounting Standards Committee (IASB) is an independent private sector body. Objectives:
  - Create uniform worldwide accounting standards (Worldwide GAAP)
  - Benefits:
    - Shareholders, lenders, employees, suppliers & customers can use one set of comparables and not have to “translate” #'s across firms from different countries.
    - Businesses have a uniform system for comparing numbers of operations in different countries.
    - Multinational companies will only have to prepare one set of statements for its worldwide operations.

# International Standards

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- Limitations of International Accounting Standards:
  - Lack of consistent enforcement and application of penalties across countries:
    - Mexican firms with ADRs (Subject to SEC rules and enforcement).
    - Even in cases of fraud, SEC did not apply penalties
    - Question: Do firms bear the cost of misreporting financial numbers?
  - Other institutions have to change as well

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