<논   문>

Accounting for the Capital Contribution in the Formation of East-West Joint Ventures

Sang-Myon Rhee*

I. Problems in Accounting for the Formation of East-West Joint Ventures

Since early 1970's, various types of joint ventures have been established between Eastern European partners, seeking Western technology and management, and Western enterprises, seeking expansion of business into Eastern Europe. The major aim of this initiation has been to make mutual benefits by complement on equal footing. These joint ventures have varied depending upon how the partners pool assets to form a joint economic entity, how the partners agree to share profits and losses, and how the partners jointly manage the enterprise. The nitial problem that the co-venturers confront when they form a joint venture is how to value the various assets which each co-venturer contributes.

Joint venture is a matter of contract; every detail should be provided in advance. Among the problems that the joint venture parties must resolve at the time of formation of a joint venture, accounting principles are the most complicated; parties frequently spend lengthy hours in negotiation. Selection of adequate accounting principles is not only important for a precise, expedient and effective management of the venture itself, but also significant to the Western firms which have to justify their business performance to the stockholders on a yearly basis. Eastern partners, however, do not share this problem, because the responsibility for financing assets rests with the government. East Europeans use different types of balance sheets and income

* S.J.D. (Harvard); a member of the law faculty, Seoul National University. The author acknowledges his gratitude to Mr. David Baker for his help and encouragement while preparing for this paper at Chadbourne, Parke, Whiteside & Wolff in New York City.

statements. For example, balance sheet formats of Romanian enterprises do not show a breakdown of liabilities as current or long term but according to the specific use of the allocated funds for different types of assets. Romanian enterprises and Western co-venturers are required to prepare an annual "Investment Plan" and a "Financial Plan" for next year's operations. They must also prepare a "Balance Sheet" with an annexed "Income Statement" showing the past year's business performance.(1)

II. Accounting for the Capital Contribution by Investors

In General, local partners would like to have a majority holding by contributing at least 51% of the capital; 51/49% contribution is the most popular. In Poland(2) and Romania(3) the local partner must hold at least 50% of the capital. Hungarian(4) decrees state that foreign participation should generally not exceed 49%. Yugoslavia(5) has legislated similar requirements, but has provided a possible modification by special act of the National Assembly. The new Bulgarian regulations opened the possibility of exceeding 50% foreign participation (for example, 65%), to be decided by the Ministry of Foreign Trade on a case-by-case basis.(6) Unlike these examples in East European countries, Chinese joint venture law provides that the proportion of the investment contributed by the foreign participant(s) in general shall not be less than 25%.(7)

Valuation process of the assets of the capital contribution in East-West joint ventures is complex because each partner, representing the dramatically different systems of price structure, usually contributes different types of assets and demands better valuation of each without the convenience of convertible currency. Westerners would argue for a sophisticated moans of valuation based

---

(1) *See* P. Verzariuand J.A. Burgess, Joint Venture Agreements in Romania at 25 (1977).
(2) *See* [Polish] Resolution No. 24 of the Council of Ministers (1979), art. 3.
(3) *See* [Romanian] Decree No. 424 (1972), art 4.
(4) *See* Hungarian Decree No. 7 (1977), art. 4.
(5) *See* Yugoslavian Foreign Investment Law (1978), art. 11(1).
(6) *See* Bulgarian Decree No. 535 (1978), art. 9(3).
(7) *See* Chinese Joint Venture Law (1979), art. 4.

on the market determined prices assuming segmentation in the market. By contrast, Easterners, living in a non-market economy where prices are determined arbitrarily by a function of government policies, are generally not familiar with the delicate and sensitive price mechanism in the capitalist world, and persist in their own methods of valuation. If co-venturers contribute only cash and other monetary assets, problems would be rather simple. East European partners, however, generally provide land and buildings while Westerners contribute not only cash and other monetary assets but also other tangible and intangible goods, such as patent and good will. Valuation of land and other goods from the local partner might be arbitrary in the context of their non-market economy. Know-how and secret process may also not easily be capitalized unless represented by specific patents or specific formulae of economic value.

Because of the various types of combinations of capital contribution from the different economic system, the methods of accounting claimed by each are frequently different. Major difficulties arise when co-ventures contribute different kinds of assets, as is generally the case in East-West joint venture, because timing of profit recognition in accounting is different depending upon the character of the assets.

III. Accounting for Monetary and Non-Monetary Assets and their Valuation

A. Investment of Cash and Monetary Assets

Accounting for cash and monetary assets by both co-venturers presents no significant problems in joint venture; each partner simply records the amount of the assets contributed on a specific date at the official rate of exchange.[8] However, problems may arise as time passes if the fluctuation of exchange rates shifts the actual balance of original ratio of contributions. It is desirable that both parties should agree in advance on this point.

(8) *See* Klink, *How to Account for Real Estate Joint Ventures*, Real Estate Review (Spring, 1974) at 121.

B. Investment of Non-Monetary Assets

Contribution of non-monetary assets raises problems of valuation. Material assets, such as land, buildings, equipment and raw materials cause less problems than nonmaterial assets, such as know-how and services. Eastern partners frequently raise questions about the productivity of the know-how and the value of services. Problems become more complex when the local governments intervene and review the whole process of the valuation of the nonmaterial contributions, even if agreements have been reached between the individual partners.

1. Recording by Joint Venture at Book Value

Local partners who contribute land and buildings would persist in accounting at book value. In the non-market economy, however, any seeming method of calculating an adequate price in the non-market economy might be arbitrary from Western partners' viewpoint. This book value method is also inconvenient for both because it will normally require yearly valuation of the local partner's contribution.[9] Local partner's persistence in accounting by book value is partially due to their unfamiliarity of the market economy and partially due to their belief that they could stand upon a better position in bargaining with the foreign partners by persisting in a pre-designated or unnegotiable fixed price in the non-market economy.

Valuation of circulating non-monetary assets, such as raw materials and goods, is also difficult, not only because price structure is different between East and West, but also because the fair market value of the contributed property frequently exceeds cost by a substantial amount. In this case, partial or whole income recognition would be appropriate.

Valuation of intangibles is basically a matter of agreement between partners. Valuation process should be different, depending upon the kinds of intangibles. Generally local governments are highly sensitive about this valuation process because its main interest is to get modern technology from foreign partners.[10]

(9) *See generally* M. Sukijasovic, Joint Business Ventures in Yugoslavia at 137 (1973).
(10) *Id.*

At the outset, local partners would insist that the equity received for know-how should be carried at book value, which would be generally no value from the local partners' viewpoint at least at the time of formation. This kind of tenacious demand is not only because of the local partner's certain misgivings about the potential productivity of the know-how, but also because of the fact that know-how would not generally result in profit until realized by the venture transactions with third parties. Thus, Western partners may not always successfully reach an agreement at a fair market price, despite its probable usefulness to reflect the possible income gains on the balance sheet. Normally, the Westerners, who contribute services, would record the cost of the services contributed plus income to the extent of the portion of the profit on the service applicable to the other investors' ownership interest. The portion of the profit to be recognized could also be based on performance, *i.e.*, on the basis of costs incurred.(11)

If all ventures contribute non-monetary assets, it is difficult to measure the absolute value of the assets, it would be appropriate to record the assets at the cost or book value, and to defer the possible gain arising from an excess of the value over the cost of the contributed assets in its entirety until confirmed later by transactions with third parties. This book value method also seems to be appropriate when the portion of total capital contributed in cash is not significant or when the co-ventures contribute monetary assets in proportion to their ownership interests and non-monetary assets in addition.(12)

However, the book value method seems to be inappropriate as a proper accounting method for East-West accounting, not only because both East and West venturers seldom contribute similar kinds of non-monetary assets, but also because it would be particularly inconvenient to the Western ventures, who would like to present the state of the venture to the shareholders as soon

(11) *See* G.C. Watt, R.M. Hammer, and M. Burge, Accounting for the Multinational Corporation (1977), at 336.
(12) *See* Klink, *supra* note 8, at 122.

as possible without waiting for the third-party transactions when the income would finally show up. Problems will arise in valuing intangible goods, because from East European partners' view a certain fair market price presented by Western co-partners may be negotiable. Eastern partners will probably demand substantial discount for the costs of know-how may already have been recovered in prior sales.(13) Difficulties in negotiation will further arise because Western co-venturers will counterargue that technology costs should include any improvements over the life of the contract.

2. Accounting by Joint Venture at Fair Market Value

Accounting at fair market value seems to be generally appropriate when co-ventures contribute different types of assets as is generally the case in most East-West ventures. Since frequently the fair market value of the coutributed non-monetary assets exceeds book value by a substantial amount, adequate income recognition would be appropriate.(14) This income recognition at fair market value will facilitate a time presentation of the status of the venture in the balance sheet.

In case Eastern partner contributes land and Westerner contributes cash, gains to the monetary contribution can be easily calculated by interest rates, and the possible profits from the land could be computed at fair market value, which seems to be generally not much different from the book value at least in the starting years. In case Western partner contributes know-how and services, he would insist on recoring at their cost together with possible income and additional investment cost, which would be as much as a fair market value. The Eastern partner, however, would insist that accounting should be done by recording at book value and that profits should be recognized only when the services have been completed and profit is measurable.

Then the problem is whether the Westerner's estimated gain is adequate and certain or whether the co-ventures should really wait until profit is measurable, until profit would be realized by the venture transactions with a

(13) *Id.*
(14) *See* G.C. Watt, R.M. Hammer, and M. Burge, *supra* note 11, at 335.

third party. Accounting at fair market value of services and know-how would expediently present the state of the ventures dealing with highly sensitive and uncertain areas with political risks.

Romanian practice of the accounting at fair market value is most interestng. The value of Romanian contribution of non-cash assets has been determined not by real social and labor costs, but by estimated price levels in convertible currency for "typical" Western markets.[15] The selection criteria for the typical markets should be decided through negotiation. However, the estimation of such typical market price is not easy in many instances. As to fixed assets, such as land and buildings, contributed by Romanian partners, an estimated fair market value in convertible currency will be calculated based on location, displacement value, utilities, etc. The market value of the site is calculated by averaging price of similar foreign sites in the West.[16] This kind of favorable guidelines reflects the Romanian desire to attract more foreign investment.

There seems to be not much difficulty in calculating estimated prices of circulating non-monetary assets contributed by either party at a fair market value, except in determining labor and other costs.

IV. Development of Methods of Accounting for East-West Joint Ventures.

Both parties may conduct any kind of joint assessment process by agreement.[17] However, in case both parties may neither agree on the book value nor on the fair market value, then both parties may settle the problem by a mediation of an expert or by arbitration of a third-party. Experiences have shown that there have been various other resourceful arrangements. For example, valuation by yearly productivity of the ten year joint venture was arranged by the Iplas-Hoechst and Unioninvest-Marlo joint ventures in

(15) *See* Verzariu and J.A. Burgess, *supra* note 1, at 19.

(16) *Id. See also* Romanian Decree(1972), art. 15. Yugoslavian law also similarly provides, "material resources and rights..... must be valued realistically in conformity with regulations." *See* Yugoslavian Law, art. 10.

(17) *See, e.g.*, Chinese Joint Venture Law (1979), Art. 5; Romanian Decree (1972), art. 15; Yugoslavian Law on Investment art. 28.

Yugoslavia by multiplying one percent of the value of yearly output by ten.[18] Similar methods have been used in the Sava-Semperit, FAP FAMOS-Daimler Benz, and OLT-Wendel cases in Yugoslavia.[19] Another method is to value the equity at an amount equal to the cash contributed by the co-venturer for a like equity interest.[20] Then, income is to be credited with an amount equal to the difference between the value assigned to the know-how and the initial book value.[21]

An alternate of its method is to value the equity of one-half of the cash contributed by the co-venturer for a like equity investment.[22] The one-half reduced valuation is based on the theory that the investor cannot make profits by selling his own know-how to himself, and that the remaining one-half is to be eliminated as an intercompany transaction.

A total value could also be computed through negotiation based on a) an initial fixed sum; b) an initial fixed sum plus yearly payments; c) just yearly payments.[23] These yearly payments could be a fixed sum or one which varies according to productivity. Each party could provide a convenient means to revise the yearly payments, if necessary. Such progressive payments could be made upon the sale of products or yearly upon the conclusion of financial accountings. Profit could also be recognized on the basis of the percentage of completion method.[24] Thus, although the method of valuation at fair market value would be generally desirable to Western partners, there still exists other harmonious arrangements agreeable between Eastern and Western coventurers.

(18) *See* M. Sukijasovic (1973), *supra* note 9, at 138.
(19) *Id.*
(20) G.K. Young and S. Bradford, Joint Ventures: Planning & Action (1977) at 56.
(21) *Id.*
(22) *Id.*
(23) *Id.*
(24) This method was set forth in the AICPA Industry Audit Guide "Audits of Construction Contractors." *See* G.C. Watt, R.M. Hammer, and M. Burge, *supra* note 11, at 336.