International Accounting

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International Accounting

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Content

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Unit 01: Introduction to International Accounting

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Objectives

After studying this unit, you will be able to:

- Know the conceptual framework of International Accounting.
- Comprehend the history and development of International Accounting
- Cognize the scope, importance and challenges in successful conduct of International Accounting.

Introduction

Accounting is known to be the language of business, through which it communicates with its stakeholders. It acts as a basic source of information for business and economic decisions. The important categories of information contained in accounting are operating information, financial accounting, management accounting information and tax accounting information. Operating information is needed for effective conduct of day-to-day activities of business. A stores' record, for example assists a manager to assess on daily basis the availability of certain items of stock for taking appropriate action to ensure that neither production not the sales get affected due to stock out. Financial accounting is needed for internal stakeholders such as managers, employees, owner and external stakeholders like creditors and government agencies. An investor, for instance, would like to decide whether to go in for buying, holding or selling security issued by a firm based on information on the firms' economic performance and cash flows. Management accounting information is needed for effective planning, implementation, evaluation and control of the firm's strategic and tactical operations. Tax accounting information is required for effective tax planning and meeting the legal requirements.

The purpose of accounting thus is to provide information that is useful for decision making. As long as the business continues to operate within its national boundaries, generating accounting information as above is never a challenge, for the accountant has to follow the same accounting standard, and operate in the same social, political, economic and legal env iron men t. Over the last few decades however, businesses have grown more globalized. Multinational corporations have emerged i n a bigger way both in quantum and size. Trade and commerce between nations have been on rise. Cross-border transactions involving flow of goods, services and capital are in an ever-increasing spree. With the increasing pace of globalization and economic liberalization, particularly towards the end of the twentieth century, executives are called upon to make decisions based on financial information originating from other countries. These decisions range from evaluating the performance of foreign subsidiaries, affiliates, joint ventures to making credit decisions on customers belonging to other countries, and making investment and financing decisions based on opportunities in other countries. Since countries have their own set of socio- economic, political, legal, cultural, technological and linguistic environment, financial reporting diversities are quite eminent. With diverse financial reports in hand, decision makers find it difficult to make effective decisions. To overcome this difficulty and to have a more uniform and harmonized financial reporting across the globe, the concept of 'international accounting' has gained momentum.

1.1 Meaning of International Accounting

'International Accounting' is that branch of accounting with various dimensions like recording and translating the foreign transactions, preparing and presenting consolidated foreign financial statements. The presentation of international financial reporting is always done in accordance with international GAAP and auditing practices.The word international in international accounting can be defined at three different levels. The first level is supranational accounting, which denotes standards, guidelines and rules of accounting, auditing and taxation issued by supranational organizations.Such organizations include the United Nations, the Organization for Economic Cooperation and Development, and the International Federation of Accountants.

In terms of the standards, guidelines, and practices that a company follows related to its international business activities and foreign investments. These would include standards for accounting for transactions denominated in a foreign currency and techniques for evaluating the performance of foreign operations. At the third and broadest level, international accounting can be viewed as the study of the standards, guidelines and rules of accounting, auditing, and taxation that exist within each country as well as comparison of those items across countries.

Definitions of international accounting

- Choi and Mueller (1979): "the heritage of accounting is indisputably international. So, today's concern with multinational accounting is more a renaissance than a new idea."
- Evans, Taylor and Holzmann (1985) defines the international accounting as the one that would involve accounting for international transactions, the operational aspects of international firms, comparison of accounting principles and practices found in foreign countries and the procedures by which they were established.
- Samuels and Piper (1985) discussed that there was nothing new about international accounting, accounting has always been international,from the time it emerged some thousands of years ago, because of its concern with internationaltrade and because of the spread of ideas across countries.
- Rathore (1996) defined international accounting as that branch of accounting which analyses the different accountingprinciples and practices prevalent around the globe, deals with the specific technical problemsencountered by individuals and MNCs in international operations and as its ultimate goal, attemptsto develop a universal system of accounting that would receive acceptance the world over."

The above views are indicative of the diverse dimensions of 'international accounting',ranging from recording of foreign transactions to the preparation and presentation ofconsolidated and comparative foreign financial statements for the use of decision makers.In nutshell, we can say that International accounting is that branch of accounting which deals withthe recording and translation of foreign transactions, preparation and presentation of consolidatedforeign financial statements, and presentation of international financial reporting in accordance withinternational GAAP and auditing practices.

1.2 Approaches of International Accounting

There is no universally accepted definition of International Accounting. It is so as there are numerous aspects of accounting that have an international dimension.Samuels and Piper (1985) states that International Accounting is a loose term. There are four approaches to better understand International Accounting, each of which is discussed below:

a) Comparative International Accounting

This approach involves a descriptive and informative approach and includes an analysis of the different accounting principles and practices that exist around the world, so as to enable the users of financial statements to understand the differences and assess their effects on the statements.

b) Politicized International Accounting

This approach originates from the involvement of world political institutions such as the United Nations (UN) and the Organization for Economic Cooperation and Development (OECD) in the harmonization of international accounting practices. The United Nations was involved in the area of corporate accounting and reporting as early as 1973, and in 1982 it set up an Inter-governmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) which is playing a crucial role in developing guidelines for transnational corporations in the area of information disclosure and accounting practices. In 1995, IOSCO entered into an agreement with IASC to complete 'Core' standards and in 2000, it recommended that its members allow multinational issuers to use IASC standards in cross-border offerings and listings.

c) Universal or World Accounting

According to this approach, international accounting would mean a universal system of accounting that could be adopted in all countries.Choi and Mueller (1992) preferred using the term 'Standardized International Accounting' that includes attempts at harmonization, i.e.at achieving similar levels of disclosure and measurement from one country to another. International organizations like International Accounting Standards Board and International Federation of Accountants Committee are already working in this direction.

d) Pragmatic or Operational International Accounting

The third approach includes the Specific technical problems encountered by domestic enterprises and multinational corporations in international business. These problems include foreign currency translation, consolidation of accounts of a parent company and its foreign subsidiaries, foreign exchange risk management, accounting for foreign inflation, performance evaluation of foreign subsidiaries and international taxation and related transfer pricing issues.

1.3 Scope of International Accounting

The scope of international accounting is both wide and vast included in which are the recording of foreign transactions, translation of foreign currency, adjustment of foreign al statements against inflation, consolidation of foreign financial statements, financial reporting and disclosure, segment reporting, multinational transfer pricing, international budgeting, performance evaluation of subsidiaries, foreign exchange risk management, international taxation, analysis of foreign financial statements, accounting for newer instruments like options, swaps and other derivative products, international joint ventures, environmental accounting, and integration of ethics into accounting. When clubbed into major groups, the scope of international accounting covers financial accounting, management accounting and social and allied accounting activities as depicted in table below:

Financial Accounting	**Management Accounting**	**Social and Allied Accounting activities**
Accounting for foreign inflation Consolidated financial statements, reporting and disclosure	Analysis of foreign financial statements Budgeting and performance evaluation of foreign subsidiaries International taxation	Accounting for mergers and acquisitions Accounting for newer financial instruments Environmental and social disclosures

Foreign currency translation Recording of foreign transactions Segment and interim reporting	Management of foreign exchange risk Multinational transfer pricing	Global joint ventures Integration of ethics into accounting curriculum Social accounting

Foreign Inflation

Price level changes refer to the increase or decrease in the purchasing power of money. Purchasing power, in turn, refers to the ability of a given sum of money to buy a certain amount of goods or services now in comparison to what the same sum of money could have bought at a previous date. The common manifestation of the changes in the purchasing power of money worldwide these days is the decrease in the purchasing power of money, called inflation.

Financial statements prepared as per the traditional methods are based on the basic assumption that the purchasing power of money is always stable. Given this assumption, and as long as it holds well, the financial statements prepared under the traditional (historical cost) method will provide useful and valid information to the decision makers. However, as the monetary unit does not remain stable due to inflation, the information contained in the financial statements without adjustments for inflation becomes highly distorted owing to misrepresentation of elements like cost of goods sold, depreciation, deferred expenses and purchasing power gains and losses. Generally, profit as revealed by the profit and loss account prepared under the historical cost method, tends to be overstated in times of rising prices (inflation). As a consequence, corporate firms lend up with, among others, paying higher taxes. Taxation of overstated profits in real term amounts to tax on capital. Financial statements too lose their credibility and interpretative benefits for overstatement of values of assets, inflated rate of return on capital, lenient distribution of dividend, higher wage payments and poor liquidity, all due to inflated profits. These reasons causing distortions to financial statements, with the associated consequences, call for the adjustment of financial statements against price level changes.

Consolidation of Foreign Financial Statements

Consolidation refers to the preparation and presentation of 'integrated financial statements', popularly known as consolidated statements, by incorporating the financial data of the subsidiary(ies), to the extent of the controlling interest, in the financial statement of the parent company with a view to giving the stakeholders information as regards the economic resources being controlled by the group. Consolidated financial statements essentially convey the results of operations and the financial position of group companies as if they were a single economic entity regardless of any legal distinctions that exist among the separate corporate entities. The purpose of consolidation is to report to the users of the financial statement the economic resources controlled by the group and also the group's obligations.

International Accounting Standard 27 provides for the presentation of consolidated financial statements in situations where one entity controls another entity. Control is said to exist when the parent owns, directly or indirectly through subsidiaries, more than one-half of the voting power over an enterprise. It may also exist even in the absence of this level of ownership if the parent has more than one-half of the voting power as a result of a voting trust or similar arrangement; the power to govern the financial and operating policies of the enterprise by operation of law or by means of an agreement, the power to appoint or remove the majority of the directors or equivalent governing persons, or the power to cast a majority of votes at the meetings of the directors or its equivalent.Indian Accounting Standard 21 also deals with the provisions for preparation of consolidated financial statements by parent companies, except when (1) a parent company acquires the controlling right in the subsidiary (through investment), which is intended to be temporary as the investment (controlling interest) is to be disposed of in the near future; and (2) the subsidiary operates under severe long-term restrictions for which its ability to transfer the funds to parent is significantly weakened. It also states that consolidated financial statements are not the substitute for separate financial statements of a parent and its subsidiary (ies).

Foreign Currency Translation

Foreign currency translation refers to the change in the monetary expression of the financial data contained in the financial statements. For example, figures of the balance sheet and income statement expressed in rupees when restated in dollar equivalent or in other similar foreign currency, a foreign currency translation is said to have occurred.The need for translation of currencies arises for consolidation of financial statements of the subsidiary (ies) located in countries other than the parent country of domicile with the financial statements of the parent company (ies). Translation is also needed in order to facilitate performance evaluation of the subsidiaries globally by restating their financial data into a common currency, i.e. the currency of the parent country. Further, translation is needed for better decision making by the stakeholders. Independent company, domiciled in one country, may also undertake translation of financial statements in a view to reaching out to the global audience of interest.The major issues vis-a-vis steps involved in foreign currency translation are:

(1) Recognition and recording of foreign currency transactions,

(2) recording of forward exchange contracts,

(3) translation (methods) of foreign currencies, and

(4) understanding the international GAAP on foreign currency translation.

Recording of Foreign Transactions

International accounting essentially begins with the recording of foreign transactions. A transaction, in relation to importing, exporting, foreign borrowings and lending, and forward contracts, taking place between parties belonging to two different countries, is said to be an international (foreign) transaction. If a British firm, for example, decides to import goods from an Indian counterpart and agrees to pay in pounds, then the transaction becomes an international one for the Indian firm as foreign currency is involved. The same transaction, however, does not amount to a foreign transaction for the British firm as the payment by the said firm is made in pounds, the firm's own currency.

International Accounting Standard (IAS) 21 provides that 'transactions whose terms are denominated in a foreign currency or which require settlement in a foreign currency' are international (or foreign currency) transactions. IAS 21 further states that foreign currency transactions arise when an enterprise

(a) buys or sells on credit goods or services whose prices are denominated in foreign currency,

(b) borrows or lends funds and the amounts payable or receivable are denominated in foreign currency,

(c) is a party to an unperformed foreign exchange contract, or

(d) for other reasons, acquires or disposes of assets or incurs or settles liabilities denominated in foreign currency.As far as recording of foreign transactions is concerned, two approaches—single transaction approach and the dual transaction approach are found to be popular. The date(s) of the transaction such as

(i) the initial transaction date,

(ii) the interim reporting date, and

(iii) the settlement date, too have bearings on the recording process.

Segment and Interim Reporting

Segment reporting refers to the reporting of financial information in relation to different business activities of the firm classified as business segment or geographical segment. The bases of classification have been stipulated in International Accounting Standard 14 and also in the Indian Accounting Standard (AS) 13. The purpose of such classification and reporting is to disclose all relevant facts, the non-availability of which will adversely affect the quality of investors' decisions.

Interim reporting refers to the presentation of financial statements of the enterprise covering periods of less than a full financial year. The purpose of such presentation of financial statements is to provide the decision makers with frequent and timely information for taking investment and credit decisions, based on their ability to predict full year's financial results from the interim results. IAS 34 issued by International Accounting Standard Committee (IASC) contains detailed provisions as regards interim financial reporting. The Institute of Chartered Accountants of India (ICAI) too has issued guidelines through pronouncement of AS 25 for interim reporting by Indian firms.

Foreign Financial Statement Analysis

Financial statement analysis refers to an information processing system that is meant for providing financial data which are appropriate and useful to decision makers who are concerned with evaluating the economic situation of the firm and predicting its future course. The information in context is derived basically from the published financial statements such as the income statement and the balance sheet of the firm. Non-accounting information like stock prices and economic indicators are also used in the process of financial statement analysis. The decision makers include a variety of stakeholders prominent being the investors, creditors, employees, regulatory agencies, environmentalists, social activists, researchers, and the management itself. Investors, for example, are concerned with portfolio decisions; creditors for determining the firm's credit worthiness; and employees for establishing economic bases for collective bargaining. The regulatory and policy formulating bodies of the state are interested in 'controlling' decisions; environmentalists and social activists on 'social accounting' issues; researchers for studying firm vis-a-vis industry behavior; and the management for evaluating the operational and financial efficiency of the firm and its subunits.

The purpose of financial statement analysis, as stated above, from the users or decision makers' perspective, is it a domestic company or a foreign company is the same. Therefore, the tools used for analyzing the financial statements of domestic company and for the MNCs would be basically the same. The most widely used techniques of financial statement analysis are: vertical or common-size analysis and ratio analysis. A few modern techniques like the Economic Value Added (EVA), Market Value Added (MVA) and Multiple Discriminate Analysis (MDA) are also used for effective analysis of the financial statements. The choice and use of any or all of these techniques would depend on the analyst's own objective and the terms of reference.

Budgeting and Performance Evaluation

Firms use budgeting and performance evaluation as tools for strategic planning and control. For multinational corporations, it is essential that these budgeting and performance evaluation tools are chosen appropriately so as to fit to the environment of the country (ies) of their own domicile and also of the foreign country (ies). The budget should be prepared in a manner as would lead to employees' motivation and goal congruence between the employees and the organization. Performance evaluation should also be appropriately designed keeping in view the domestic and the international environment in which the subsidiaries and affiliates operate.

"If the budget is to motivate the employees and to help create goal congruence between the employees and organization, then it must set appropriate criteria and provide reasonable targets for the employees to attain. Along with all the budgeting and performance evaluation issues that organization must contend with in the purely domestic context, there are additional considerations that must be factored into designing budget and performance evaluation systems for subsidiaries and affiliated entities located in other countries".

Transfer Pricing

Transfer pricing relates to the pricing of goods and services that change hands between entities engaged in inter-firm trade. Transfer price is the price at which goods or services are transferred between affiliated entities within an organization. IAS 14 on segment reporting defines transfer pricing as "the pricing of products or services between industry segments or geographic areas". The term transfer price is more popular among multinational corporations than the domestic firms for transfer of materials, parts or finished products and services.The need for transfer pricing system arises primarily to communicate data that will lead to goal-congruent decisions. Appropriate evaluation of segment vis-a-vis managerial performance and avoidance of foreign currency restrictions and quotas, minimization of taxes and tariffs, minimization of exchange risks, avoidance of profit repatriation restrictions and enhancement of shares of profits in joint ventures are some of the other important objectives that are accomplished through transfer pricing mechanism. The methods used for transfer pricing are cost-based, market-based and negotiated prices.

Exchange Risk Management

Exchange risk management aims at monitoring and managing the firm's foreign exchange exposure so as to maximize its profitability, cash flow and market value. Foreign exchange exposure primarily assumes three forms: Translation exposure, transaction exposure and economic exposure.Translation exposure refers to the potential of an increase or decrease in the parent company's net worth and reported net income due to fluctuations in the exchange rates. In contrast, transaction exposure arises due to the sensitivity of the firm's contractual cash flows denominated in foreign currency to exchange rate fluctuations. Translation exposure arises from (1) buying and selling on credit goods or services whose prices are contractually denominated in foreign currency, (2) borrowing and lending funds in foreign currency, (3) forward exchange contracts, (4) acquisition or disposal of assets denominated in foreign currency, and (5) settlement of liabilities denominated in foreign currency.Economic exposure refers to the extent to which the value of the firm would be impacted by unexpected changes in the exchange rates. The managerial efforts to manage economic exposure would be to formulate long-term strategies so as to enhance and preserve its value in the event of unexpected exchange rate fluctuations.

International Taxation

International taxation is a complex phenomenon that affects all the aspects of multinational operations including foreign investments, transfer pricing, marketing of product and services, cost of capital and capital structure. It is therefore imperative for multinational corporations in particular to understand the diversities that exist in relation to corporate tax laws in different countries for better (tax) planning and decision making.

1.4 History and Development of International Accounting

The concept of International Accounting was discussed by many academic researchers like

a) Danik J.Y; b) Luchko M.R;

c) Pushkar M.S; d) Tkach M.V;

e) Goma A; f) AhamdS;

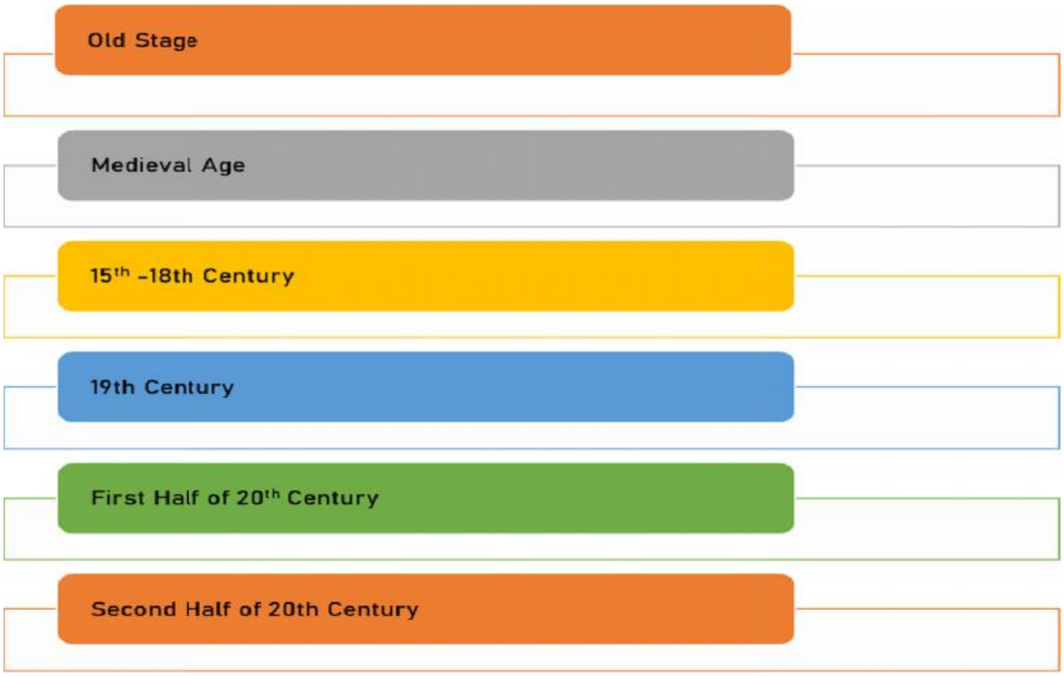
g) PereraH; h) Meuller G; Flasher D. etc.

Its' worth mentioning here that the development of International Accounting has not been considered in a holistic way that would emphasize various stages of development and consider distinct factors that influenced accounting at those stages.In year 2002, F.F Butynets discussed International Accounting to be with a wider scope. As a system of Accounting it is not merely a collection of interconnected elements, rather also as the one which is interconnected with an environment within which it exists.

V.I. Tkaach and M.V. Tkaach suggested 5 main stages of development as given below:

- **Stage 1: Trade Stage (Until 1800)**
- **Stage 2: Entrepreneurial Stage (up to 1900)**
- **Stage 3: Organization Stage (until 1950)**
- **Stage 4: Optimization Stage (between 1950)**
- **Stage 5: Strategic Stage (since 1975)**

Y.A. Mizikovski and T.Y. Druzhilovska suggested six main stages:



Interestingly Right around the end of 19th and at the beginning of 20th centuries there occurred a series of significant events which have contributed to development of international system of accounting.1.5 Importance of international accounting.At the end of 19th and beginning of 20th centuries, several countries passed laws for creating a legal accounting framework. At the same time, several professional accounting associations were created which later had a significant impact on establishment of an international system of accounting. Such associations include Institute of Accountants in Edinburgh and Glasgow (created in 1853), Society of Accountants in Aberdeen (1867), Manchester Institute of Accountants (1887), Scottish Institute of Accountants (1880), American Association of Public Accountants (1887), Canadian Institute of Chartered Accountants (1902), London Association of Accountants (1904) etc. If we consider the stages of development of accounting (according to classification proposed by V. I. Tkach and M. V. Tkach), international system of accounting was a part of the organizational stage of development which lasted until 1950s. In 1904 the first International Congress of Accountants took place in St. Louis, Missouri (USA). At the congress were represented not only American Accountants but also accountants from England, Scotland, Netherlands and Canada. This congress can be considered as a first significant event in establishing an international system of accounting.

The main issues discussed at the congress were consolidation of accounting profession, growth of world economy, development of auditing firms, establishment of standards for calculating corporate profits (Dennis, 2004).During the congress, participants considered which accounting services are necessary for end users and what needs to be done to satisfy the needs of the users of accounting information.Even though at this congress, international aspects of accounting were not addressed directly, it laid the groundwork for productive discussion in this area. This was evidenced by the next congress which took place in 1926 in Amsterdam, where 370 attendees represented 15 countries. The goal of the congress was to share knowledge, experiences and methodologies from different countries, to seek universal treatment of cost accounting that would be acceptable internationally. The goal of the congress was to share knowledge, experiences and methodologies from different countries, to seek universal treatment of cost accounting that would be acceptable internationally.

At this congress, materials were translated into English, French and German. Most questions raised at the congress were closely tied to global economic development and internationalization. At this congress there was even a proposal to create an international prize similar to Nobel Prize for advances in accounting (Ahmad, 1975, p. 78). It was around this time when the first transnational corporation became reality. They were primarily focused on extraction of natural resources from colonial countries in Asia, Africa and Latin America and processing those resources at the facilities based in the colonizer countries (Poliakov, in year 2008, p. 46).The next important milestone in development of international system of accounting according to V. F. Paliy, was a stock market crash of 1929 which led to subsequent global depression in developed countries. This crash exposed deficiencies in existing systems of accounting and financial reporting. There were deep differences in principles of financial reporting across countries and even across companies within the same country.

Reporting was not always perceived correctly by the users of accounting information. Information was not suitable for analysis of economic entities and led to erroneous and conflicting conclusions about business activities and financial conditions of companies (Paliy, in year 2008, p. 5). This point of view is also supported by Shturmina. She notes that it was the financial crisis in USA that led to creation of nationally recognized standards of accounting and reporting which were adopted by corporations whose stocks were traded on exchanges (Shturmina 2010, p. 12). According to F. F. BATNETS Butynets, at the beginning of 20th century, it became clear that traditional accounting did not keep up with the needs of management inan increasingly competitive environment, rapidly changing technology and growing complexity of organization of production (Butynets, 2002, p. 23).Therefore, the first stage of development of international system of accounting was marked by creation of a legal framework for accounting in some countries, establishment of professional accounting associations, rethinking ofthe role of accounting.Interest in international system of accounting grew toward the end of 1950s due to the fact that following the end of World War II there was increasing global economic integration which also lead to increase in capital flows, international trade and foreign direct investment.

As noted by F. F. Butynets, since the middle of the 20th century, due to expansion of international economic relationships, specialization and cooperation of production, creation of transnational corporations, the problem of incompatibility of accounting and auditing standards became of paramount importance (Butynets, 1999, p. 527).During this time, Europe started its movement toward unification. In 1951, European Coal and Steel Community (ECSC) was created, in 1957 European Economic Community (EEC) and European Atomic Entergy community are established (Euratom), and in 1960 European Free Trade Association is formed.During the 1960s, there was period of international mergers and acquisitions, particularly between American and European companies. In April of 1963, Business Week carried out a study on new form of business organization which was named Multinational Corporation.Such international trends strengthened the need for a meaningful comparison of financial reporting that originated in different countries (Zeff, 2012). The middle of 20th century could be considered the second stage of development of international system of accounting.

In the same year, AICPA established its own committee on international relations whose aim was to create programs for improving international cooperation between accountants of different countries and fostering exchange of information and ideas. In 1964 the committee published a survey of accounting standards of 25 countries (Professional Accounting in 25 Countries) that is considered to be the first attempt to research accounting, auditing and reporting standards on international level (Zeff, 2012).In 1962, under the aegis of American Institute of Certified Public Accountants (AICPA), the 8th International Congress of accountants took place in New York. The central issue in the discussions that took place was the impact of global economy on accounting.Many participants of the congress stressed the urgency to make progress toward development of auditing and accounting practices as well as reporting standards on international level.An important step in development of international system of accounting took place in 1966 when Henry Benson, a senior partner at a British accounting firm Cooper Brothers & Co. (later Cooper and Lybrand and currently Price Waterhouse Coopers)who served at the time as a president of Institute of Chartered Accountants of England and Wales, visited United States and Canada. He and the presidents of AICPA and Canadian Institute of Chartered Accountants reached an agreement to create Accountants International Study Group (AISG) that would study accounting and audit in these countries. AISG took shape in 1966–1967 when representatives of professional accounting associations from Canada, United Kingdom and United States joinedforces in attempt to harmonize accounting and auditing practices and form a long-term strategy for creating a set of international accounting standards. AISG functioned for ten years and published twenty guidelines before ceasing its existence in 1977. Studies conducted by AISG further highlighted difference in accounting practices between these three countries and, naturally, lack of consistency in reporting standards on a global level.

In 1967, was published the first textbook on international accounting that was written by Gerhard G. Mueller. His biographer, Dale L. Flesher, considers Mueller to be the father of international accounting andclaims that it was Mueller who, through his academic work, spurred development of international accounting as a research field, and his impact was felt in both among theorists and practitioners.Muellerwas the first professor to offer international accounting as a field in a graduate school. He prompted development of research in international accounting in two directions: first he focused on importance of differences among international accounting and theirsignificance for accounting profession and businesses who take part in international trade; second, he emphasized importance of learning about differences in how accounting is taught in different educational institutions (Flesher et al., 2010).

In 1972, at the 10th International Congress of Accountants in Sidney, representatives of AISG met to discuss a proposal to create an International Accounting Standards Committee (IASC). The committee was formed in London in 1973 with participants from Australia, Canada, France, Germany, Japan, Mexico, Netherlands, Great Britain, Ireland and United States.This entity was an independent, non-profit, non-government organization aimed at developing unity in accounting standards that would be used all over the world. Henry Benson was elected as the first chairman of IASC. A unique feature of this committee was that it was created by professional associations directly involved in accounting rather than governments of respective countries. A year later, representatives of Belgium, India, Israel, New Zealand, Pakistan and Zimbabwe joined association as associate members. The first IASC standard about transparency of accounting policy was issued in January of 1975.On October 7th, 1977, at the 11th International Congress of Accountants in Munich, the International Federation of Accountants was founded. This organization was created with the aim of strengthening of accounting profession in the world in the interest of society.

The organization was responsible for creation of high-quality international standards of auditing and accounting of private and government sector, development and implementation of ethics andeducation for professional accountants, fostering cooperation among members and with other international organizations, serving as international representative of accounting profession.Thus, an important event in the second stage of development of international system of accounting was creation of two organizations: International Accounting Standards Committee and International Federation of Accountants. These two organizations had similar yet different goals: While IASC Was responsible for developing standards for accounting and reporting, IFAC functioned as a global organization of accounting profession and dealt with problems of accounting and audit.Following creation of these two organizations, development of international accounting was focused on development of international standards and their gradual implementation marked by further recognition of IASC and IFAC as theprimary global institutions of account professions that were in close cooperation with other leading global organizations.

In 1980, several major multinational corporations expressed their support of IASC. In particular, General Motors, Exxon and FMC stated that their annual reporting largely follows International Accounting Standards (Zeff, 2012, p. 813).In 1981, IASC Consultative Group was formed and it included representatives from the World Bank, United Nations, Organization for Economics Cooperation and Development and other members of world community. In 1987 International Organization of Securities Commissions joined the group, and in 1990 European Commission and Council of Financial Accounting Standards Board (USA) joined in observer status.From 2000, International Organization of Securities Commissions recommended using IAS by transnational corporations and on the world financial markets. Developing countries used IAS as a basis for developing their own accounting standards. Lebanon and Zimbabwe, for example, legally required international standards to be used by banks and publically traded companies. Developed countries such as Belgium, France, Italy and Germany also passed laws allowing publically traded companies to present their consolidatedfinancial statements using IAS without resorting to domestic accounting standards. At the endof 1990s, IAS were approved by G7 countries (USA, Japan, Germany, Great Britain, France, Italy and Canada), Basel committee on Banking supervision and Bank for International Settlements (Veron and Nikolas, 2007, p. 11).By 2000, 143 professional accounting organizations from 104 countries joined IASC and membership of IFAC grew from 63 founding organizations from 51 countries to 173 full and associate members from 129 countries and jurisdictions (IFAC History).From 1973 to 2003, IASC issued 41 standards under the common name International Accounting Standards as well as a Conceptual Framework. In the first years of its existence, IASC focused its efforts on creation of international accounting standards. However, their implementation had little success because most major developed nations continued to use their own accounting standards, commonly known as Generally Accepted Accounting Principles. Although members of IASC pledged to cooperate with and facilitated the development of IAS, at the end of the day they did not treat these standards as their nationally accepted standards. The reasons for the lack of support for IAS have been studied extensively. For example, Basoglu and Goma note that a) international accounting standards were not sufficiently complete b) international accounting standards were excessively flexible. The standards allowed for too many alternative calculations and interpretations and that was unacceptable for accounting practitioners in most countries (Basoglu and Goma, 2002).Doupnik and Pererra pointed out the IASC activities were perceived as lacking legitimacy: There was inadequate support for its founders; IASC was not sufficiently independent; some committee members were believed to lack required expertise (Doupnik and Perera, 2007, p. 26–142).After careful consideration, in 2000 IASC changed its name to International Accounting Standards Board (IASB) and the standards developed by this entity were also given a new name after 2001 – International Financial Reporting Standards (IFRS). This name change came with a fundamental change in the structure of the organization as well as its mission: Instead of striving for harmonization of accounting standards, the goal was stated as «convergence» of national accounting standards with international standards of financial reporting.Therefore, at the turn of 21st century, efforts to harmonize accounting systems across the world morphed into a broader concept of «international convergence».

In 2002, European Union legislated the use of IFRS for financial reporting by publically traded companies starting in 2005. At the same time, EU decided to use its own «European» version of IFRS whose standards have been approved by the European Commission. IFRS and their interpretations that were accepted by EU were made available in all official languages of EU and are published in an official journal of EU. This decision to make IFRS the official standards influenced their further proliferation into more countries. According to Veron Nicholas, gradual modification of national standards of accounting and their gradual convergence with IFRS, namely in developed countries, would have been unlikely to occur if it wasn't for adoption of IFRS by EU (Veron and Nicolas, 2007, p. 16).Almost simultaneously with EU's decision, Financial Reporting Council (FRC) of Australia announced its acceptance of IFRS by January 1 2005. In December of 2002, Financial Accounting Standards Board (USA) and IASB conducted a joint meeting in Norfolk, Connecticut (USA) and pledged future cooperation in moving IFRS and GAAPtoward a common set of standards. Representatives of FASB recognized the need for high-quality international accounting standards to be used for financial reporting by multinational corporations (IFAC History).Taking into account the fact that GDP of USA is more than 20% of the world GDP, support for such standards would have a substantial impact on the success of their implementation.Therefore, starting in 2000, international system of accounting receives global support and spreads into many countries all over the globe. Today, according to information published by IASB and Deloitte and Touche Tohmatsu Limited, implementation of IFRS can be described as follows:

Requirement for Using IFRS	Number of countries	
	Listed companies	Unlisted companies
IFRS not allowed	24	32
IFRS allowed	25	45
IFRS required for some companies	11	34
IFRS required for all companies	92	27
No stock exchange	21	–
No information	–	35
Total	173	173

It should be noted that it could be hard to gauge true level of proliferation of IFRS, partly due to conflicting or absent information. When analyzing information from 173 countries, Deloitte and Touché noted that some countries that use their own accounting standards still state that their standards are either based on, comparable to or even correspond to IFRS. In addition to that, there are substantial differences in terminology, classification of accepted standards, the deadline for their adoption. Sometimes IFRS are adopted only partially. Therefore, IFRS is used probably in even fewer countries (Use of IFRS by jurisdiction). Summarizing information presented in table, we note that today IFRS is either permitted or required for either full or partial use by publically traded companies in 128 countriesin the world and by unlisted companies in 106 countries. Such widespread use of IFRS demonstrated global acceptance of international system of accounting.

1.5 Factors Affecting Development of International Accounting

Thefactors,whichhavecontri butedtowardsthedevelopmentofinternationalaccounting, are:

l. Expansionofworldtrade: Overthepastfewyears,countrieshavebecomeincreasinglyinterdependent in termsofgoods,servicesandflowofcapital.Unliketheearlycaravanshousedtocrossnationalboundaries sellingtheirwares,thepastoneandhalfdecadeshave witnessedasurgeinthevolumeofinternationaltradebetweencountriesasaresultofmodernmeansof transportandcommunication.Thevalueofworldexport,forexample,hasincreasedfrom

59.6billionUSOintheyear 1950to15459 USO by the end of 2009.Consequently, thecomplexitiesinvolvedin accountingpractices because of theinvolvementof so manycountrieshaveincreased. Thishasnecessitatedestablishingharmonyinaccountingpracticesacross nationsand therefore thedevelopment of international accounting.

2.Emergenceofmultinationalcorporations: Proliferationsofmultinationalcorporationshavebeenseenas animportantcontributoryfactortowardsthedevelopmentofinternationalaccountingasadistinctdiscipline.Multinationalcorporationsoperateunderdifferentialtariffs, taxes,governmentregulations, political risks,inflations,currencies,andaccountingpolicies /standards.Assuch,consolidationofthefinancialstatementsofsubsidiariesbecomesdifficultintheabsenceofauniformaccounting method, whichinfactisfulfilledbyinternationalaccounting.

3. Increase in international flowof capital: Internationalflowofcapitalhasbeenontheriseoverthepastfewyears. Forinstance,theamountofdebtcapitalraisedintheinternationalcapitalmarketscornledover$328billionin l989comparedto$50 billion in 1980.Anotherexample of theinternationalflowof capitalize evidentinthefactthatby the end of 1997asmany as343non-UScompaniesfrom46nationswithanaggregatemarketcapitalizationofUS$3trillion,asagainstatotalmarketcapitalization ofUS$1l.6trillion,were listedontheNewYorkstockexchange.Thisincreasingdependenceoninternationalmoneyandcapitalmarketshaswarrantedforcomparableandreliablefinancialinformationforthepresentand potentialinvestorsspreadacrosstheglobe.Internationalaccounting,byvirtueofharmonizationofaccountingpractices,helpsproduce morereliableandcomparablefinancialinformation,andisthereforea boon in this direction.

4. Historicalevolutionofaccounting: Internationalaccountingi s significant in the accountingevolutionitself.The doubleentrysystemofbook-keeping,consideredasthefoundationofmodernaccounting,originatedinItalyin1493andspreadto Germany,FranceandNetherlandsinthesixteenthcentury.Britain'spolitical supremacyovertheworldintheseventeenthandeighteenth centuriesenabledittotransferitsaccounti n gandaud i tingtechnologynoton lycotheUSbutalsototheBritishCommon wealth countries.And inthetwentiethcentury,theemergenceoftheUSasa strongeconomicpowerresultedinthe transfer ofUSaccounting thought (suchastheUSGAAP) almost totherestof theworld.Thesesequentialdevelopments ofaccoun tingthoughtsrepresentaninternationalcharacterofaccountingirrespectiveofnationalistictendencies.

5.Need forharmonizationofaccounting practices: Theneedforharmonizationofaccountingpracticeshasalsoled tothedevelopmentofinternationalaccounting. Harmonization refers totheprocessofminizationofdiversitiesinfinancialreportingpracticesthatexist among nations so as to make the financialstatementscomparableanduseful todecisionmakers.Diversities inaccounting practicesactasahindranceto the international flow ofcapital for itsefficient and productive use.Thisisbecauseinternationalinvestors find it difficult to read theaccountingfiguresofothernationsthat arepreparedbasedon differentsetofaccountingrulesandlanguageofthenation.It is through the harmonization ofaccounting practices development chatthesebarriersarcremovedto a great extent.Developmentofinternationalaccountinginitself isthemanifestationofharmonizationofaccountingpracticesacrossthe globe.Overandabove,mosteconomiesintheworldhaveagreedtoadopttheInternationalFinancialReportingStandards(IFRS)asthebaseforreporting financial performanceof theircompanieswhichinitselfwillresultintheremovalofdisparitiesinfinancialreporting.InIndia,forexample,companieswhicharepareofNSEIndex-Nifty50,companieswhicharepartofBSESensex-BSE30,companieswhosesharesorochersecuritiesarelistedonastockexchange outside India,and companies,whetherlistedornot,having paidcapitalornetworth ofRs. 1,000croreormorewillbeadopting toIFRSfrom April2011.

1.6 Importance of International Accounting

1. Facilitates achieving harmonization of accounting practices across nations.

2. Helps in reaching out to Global Investors
3. Helps in taking informed decisions
4. Helps in mobilizing global resources
5. Helps in establishing uniformity in global financial reporting and disclosure practices
6. Helps in professionalization of accounting education world wide
7. Helps in including ethics and transparency into accounting practices

1.7 Difficulties in International Accounting

Operational complexities and diversities owing to socio-economic, political, cultural, technological and perpetual differences existing among nations worldwide.Nature and extent of these diversities vary not only across countries but also from trivial to sustentative in terms of intensity.Trivial differences are, for example, what is called Sales in US is turnover in UK.A major difference in terms of accounting philosophy is found in Germany where, among others, the emphasis is laid on 'creditors' protection' and accordingly the accounting reporting.

Leftwhich contrasted in accounting' and accounting treatment across the globe amply demonstrate the prevalent diversities in world accounting. German accounting is heavily influenced by desire to protect creditors, and income taxes in Germany are based primarily on externally reported accounting profit, so there are strong legal and economic pressures to report income and asset values conservatively.Consequently, German accounting standards require that allowances be made for all possible losses. Since virtually anything can be deemed possible, management has considerable flexibility when determining appropriate allowance.

Contrasts in accounting philosophy		
Basis of difference	On one hand	On the other
Primary purpose of external financial reporting	Provide information to stock holders (Eg; US and UK)	Protect creditors; guard against reporting information that will harm the company competitively (e.g; Japan and German)
Guidance provided by standards	Very specific operational and implementation details (eg: US)	Broad principle only, allowing management considerable discretion for many transactions (eg: Japan and Germany)
Topics covered by Standards	Specific individual standards provide extensive coverage of major and minor business activities, including, for example how to account for the costs of modifying computer software to cope with the year 2000 (US)	No specific individual standards for some major business activities (eg: post-employment health benefits in Canada, Germany and Netherland).
Relationship to Income Tax Laws	External reporting and tax reporting based on such different rules that, there are essentially two sets of books (eg: Australia, Us, Canada	Income atx is based heavily on externally reported income (eg: Germany, France and UK)

	and Netherlands)	
Reporting Frequency	Quarterly	Semi-Annually
Disclosure of accounting adjustments (transparency)	Extensive footnotes and narrative discussion of choices and applications of accounting methods, estimation and techniques, transfer to and from reserves and provisions, and other accounting adjusting entries (eg: Australia, New Zealand, Canada, UK and US)	Considerable aggregation of asset and liability classes, few footnotes, and, at the most, cryptic comments about how accounting standards are applied, transfer to and from reserves, and the basis for various accounting adjustments (eg: France, Japan, Switzerland and Germany)
Charges against owners' equity	Clean surplus-virtually all charges, including cumulative effects of changes in accounting choices, must flow through the income statement 9eg: US and with more exceptions, the UK)	No clean surplus-some charges, especially those associated with prior-period effect of changes in accounting methods, can be made directly retained earnings (eg: Germany)

Summary

International accounting has both advantages and disadvantages. Its major advantage relates to:

- Achieving harmonization of accounting across nations
- Reaching out to global investors
- Making informed decisions
- Mobilizing global resources
- Establishing uniformity in global financial reporting and disclosure practices
- Professionalization of accounting worldwide - including ethics and transparency into accounting practices.
- Its' limitation lies with effect that a uniform accounting practices worldwide is difficult, if not impossible, due to presence of socio-economic, political, cultural, technological and perpetual differences among nations.

Keywords

'International Accounting' is that branch of accounting with various dimensions like recording and translating the foreign transactions, preparing and presenting consolidated foreign financial statements.

Inflation: It is the rate of increase in prices over a given period of time. Inflation is typically a broad measure, such as the overall increase in prices or the increase in the cost of living in a country.

Price level changes refer to the increase or decrease in the purchasing power of money.

Consolidation refers to the preparation and presentation of 'integrated financial statements', popularly known as consolidated statements.

Foreign currency translation refers to the change in the monetary expression of the financial data contained in the financial statements.

Transfer pricing relates to the pricing of goods and services that change hands between entities engaged in inter-firm trade

Self Assessment

1. ______ refers to as a change in monetary expression of the financial data contained in financial statements.

A. Transfer Pricing
B. Translation
C. International Taxation
D. Budgeting and Performance

2. Who defined International accounting as "that branch of accounting which analyses the different accounting principles and practices prevalent around the globe, deals with the specific technical problems encountered by individuals and MNCs in international operations and as its ultimate goal, attempts to develop a universal system of accounting that would receive acceptance the world over"?

A. Evans, Taylor and Holzmann
B. Samuels and Piper
C. Rathore
D. Meuller

3. _______ is a complex phenomenon that affects all the aspects of multinational operations including foreign investments, transfer pricing, marketing of product and services, cost of capital and capital structure.

A. International taxation
B. Transfer Pricing
C. Exchange Risk Management
D. Budgeting

4. Multinational Corporation can be defined as a firm which____________.

A. is having all government benefits of origin country
B. is counted amongst biggest industries in host country
C. owns companies in more than one country
D. all of the above

5. The major issues vis-a-vis steps involved in foreign currency translation are:

A. recognition and recording of foreign currency transactions
B. recording of forward exchange contracts
C. Translation (methods) of foreign currencies and understanding the international GAAP on foreign currency translation.
D. All of the above

6 . Multinationalcorporationsoperateunder_ _ _ _ _
A. Differentialtariffs, taxes
B. Governmentregulations
C. Politicalrisks andinflations
D. All of the above

7. IASC stands for _____
A. International accounting standard committee
B. Indian accounting standard committee
C. International accounting standard company
D. Indian accounting standard company

8. IASC established in the year
A. 1963
B. 1973
C. 1983
D. 1993

9. IASB Stands for
A. National accounting standard Board
B. Indian accounting standard Board
C. International accounting standard Board
D. None of the above

10. IAS in accounting stands for____
A. International accounting standard
B. Indian administrative services
C. Indian accounting standard
D. None of the above

11. Inflation is measured by _______.
A. Wholesale price index
B. Marshall's index
C. Consumer price index
D. None of the above

12. Identify which of the given is a cause of inflation in India are ___________.
A. The inadequate rise in industrial production
B. Erratic agricultural growth
C. Deficit financing
D. inadequate rise in industrial production, deficit financing and erratic agricultural growth

13. Which of the following best describes "Market Value Added"?
A. The difference between the market value of the firm and the amount ofcontributed capital.
B. The value added to the product the firm produces above and beyond the costs ofthe inputs.
C. The difference between the book value of equity and debt versus the market valueof the firm.
D. None of the above accurately describes Market Value Added.

14. Transfer pricing is due to:
A. Countertrading by countries
B. A way for International marketers to avoid paying tax
C. The operations of parallel or 'grey' marketers.
D. International marketers transferring goods and services in their organization between different countries.

15. How economic value is added (EVA) calculated?
A. It is the difference between the market value of the firm and the book value of equity.
B. It is the net income of the firm less a dollar cost that equals the weighted average cost of capital multiplied by the book value of liabilities and equities.
C. It is the firm's net operating profit after tax (NOPAT) less a dollar cost of capital charge.
D. None of the above are

Answers for Self Assessment

1.	B	2.	C	3.	A	4.	C	5.	D
6.	D	7.	A	8.	B	9.	C	10.	A
11.	C	12.	D	13.	A	14.	D	15.	C

Review Questions

1. Discuss the factors that induced international accounting.
2. What are the different approaches of international accounting?
3. Discuss the scope of international accounting in detail.
4. Explain the importance and challenges of international accounting
5. Write a short note on:
    a. Transfer Pricing
    b. Foreign Inflation
    c. Segment and Interim Reporting
    d. Foreign Financial Statement Analysis
    e. International taxation

Further Readings

- INTERNATIONAL ACCOUNTING By DAS MAHOPATRA, PRENTICE HALL
- INTERNATIONAL ACCOUNTING by RATHORE, SHIRIN, PRENTICE HALL

Web Links

- https://slideplayer.com/slide/12662224/
- https://www.hult.edu/blog/international-business-challenges/
- https://www.henryharvin.com/blog/indian-accounting-standards/
- https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/view-jurisdiction/india/
- https://vidyaprasar.dei.ac.in/wp-content/uploads/2021/09/LESSON-1-CONCEPT-SCOPE-OF-INTERNATIONAL-ACCOUNTING.pdf
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- https://www.academia.edu/11512199/HISTORY_OF_ORIGINS_AND_DEVELOPMENT_OF_SYSTEM_OF_INTERNATIONAL_ACCOUNTING

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Unit 02: Interaction between International Accounting and its Environment

CONTENTS

Objectives

After studying this unit, you will be able to:

- Identify the factors affecting the International Accounting
- Cognize the relevance of comprehending the factors affecting the International Accounting

Introduction

As a social science accounting is affected by the environment in which it operates, but at the same time, it is one of the factors impacting on this same environment. This is a fact that points to the interdependency of accounting and its environment. A country's accounting system is affected by a variety of historical, economic, socio – cultural, institutional, and other non – accounting factors. So, it is highly unlikely for the influential factors of any two countries to be exactly the same. Therefore, it can be logically assumed that the factors affecting the development of a country's accounting system are also the generators of special national traits and, thus, the generators of differences between accounting systems at the international level. Several comments on influential factors can be singled out from the literature.

2.1 Meaning of International Accounting

International business is all about trading the goods, services, technology, capital and/or knowledge across national borders and at a global or transnational scale. An international business environment refers to the surrounding in which international companies run their businesses. Therefore, it is mandatory for the people at the managerial level to work on the factors that comprise of International Business Environment.

For Example: 1. A business manufacturing certain components or products abroad but sells them domestically. 2. Organization outsourcing the services to its clients at various locations where labour expenses are cheaper.

2.2 Difference between Domestic and International Business

Basis for Comparison	Domestic Business	International Business
Meaning	A business is said to be domestic, when its economic transactions are conducted within the geographical boundaries of the country.	International business is one which is engaged in economic transaction with several countries in the world.
Area of operation	Within the country	Whole world
Quality standards	Quite low	Very high
Deals in	Single currency	Multiple currencies
Capital investment	Less	Huge
Restrictions	Few	Many
Nature of customers	Homogeneous	Heterogeneous
Business research	It can be conducted easily.	It is difficult to conduct research.
Mobility of factors of production	Free	Restricted

2.3 Environmental Factors Affecting Development of International Accounting

I. Economic environment: These are external factors in a business market. It is important to note that the broader economy that can influence a business. Such an environment can be divided into microeconomic and macroeconomic environment. The former affects business decision making such as individual actions of firms and consumers affects entire economy and all its participants.Many economic factors act as external constraints on your business, which means that you have little, if any, control over them. Economic factors can be further classified as:

A. Macroeconomic factors: It influences are broad economic factors that either directly or indirectly affect the entire economy and all of its participants, including your business. It includes:

1. *Interest rates:* The interest rate is the amount a lender charges a borrower and is a percentage of the principal—the amount loaned. The interest rate on a loan is typically noted on an annual basis known as the Annual Percentage Rate (APR)

2. *Taxes:* A tax is a mandatory fee or financial charge levied by any government on an individual or an organization to collect revenue for public works providing the best facilities and infrastructure. The collected fund is then used to fund different public expenditure programs.

3. *Inflation*: Inflation is a measure of the rate of rising prices of goods and services in an economy. Inflation can occur when prices rise due to increases in production costs, such as raw materials and wages. A surge in demand for products and services can cause inflation as consumers are willing to pay more for the product.

4. *Currency exchange rates:* Exchange rate is the price of one currency in terms of another currency. It can be either fixed or floating. World trade now depends on a managed floating exchange system. Governments act to stabilize their countries' exchange rates by limiting imports, stimulating exports, or devaluing currencies. An exchange rate can be either fixed or fluctuating by nature. An exchange rate is "fixed" when countries use gold or another agreed-upon standard, and each currency is worth a specific measure of the metal or other standard. A Fixed exchange rates gets decided by central banks of a country whereas the floating exchange rates are decided by the mechanism of market demand and supply. An exchange rate is "floating" when supply and demand or speculation sets exchange rates (conversion units). If a country imports large quantity of goods, the demand will push up the exchange rate for that country, making the imported goods more expensive to buyers in that country. As the goods become more expensive, demand drops, and that country's money becomes cheaper in relation to other countries' money. Then the country's goods become cheaper to buyers abroad, demand rises, and exports from the country increase.

5. *Consumer discretionary income:* This can basically be defined as any income remaining after all essential expenses have been paid. Essential expenses include taxes, housing, utilities, food and clothing.Businesses are often concerned over how much discretionary income consumers have because this is the money that the consumers have left to purchase non-essential goods and services.

6. Savings rates: The savings rate is a measure of the amount of money which an individual deducts from his/her disposable personal income to keep aside as a nest egg or for retirement, expressed as a percentage or ratio.

7. Unemployment rate: The unemployment rate is determined at the national level and at state or regional levels via labor-force surveys conducted by the national statistical institute in each country. Organizations such as the organization for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF), and the World Bank also calculate and record the national unemployment rates of large numbers of countries throughout the world on an ongoing basis.When the economy is in poor shape and jobs are scarce, the unemployment rate can be expected to rise. When the economy is growing at a healthy rate and jobs are relatively plentiful, it can be expected to fall.

8. Recession: A sustained period of weak or negative growth in real GDP (output) that is accompanied by a significant rise in the unemployment rate is better known as Recession. Many other indicators of economic activity are also weak during a recession. It is a period of economic contraction, where businesses experience less demand and begin to lose money. To cut costs and stem losses, companies begin laying off workers, generating higher levels of unemployment.For instance, levels of household spending and investment by businesses are usually low. In addition, the numbers of households and businesses that are unable to pay back loans are unusually high, as is the number of businesses that close down. Because these indicators are typically present when there is a significant increase in the unemployment rate, the unemployment rate is considered a reliable and timely summary indicator of a range of negative developments in an economy.

9. Depression: It is a major downturn in the business cycle characterized by sharp and sustained declines in economic activity; high rates of unemployment, poverty, and homelessness; increased rates of personal and business bankruptcy; massive declines in stock markets; and great reductions in international trade and capital movements. A depression may also be defined as a particularly severe and long-lasting form of recession, where the latter is generally understood, relative to a national economy, as a period of at least two consecutive quarters of decline in real (inflation-adjusted) GDP, or grossdomestic product.

B. Microeconomic factors: These influence how your business will make decisions. When compared with the macroeconomic factors, these factors are far less broad in scope and do not necessarily affect the entire economy as a whole. Microeconomic factors influencing a business includes:

1. Market size: It is the maximum total number of sales or customers your business can see, often measured over the course of a year. It's helpful to know the potential market size before launching a new product line or line of business, since that can help you understand if it's a worthwhile investment of your time and money. A related concept is market share, which refers to the total part of the market a business has as its sales or customers.

2. Demand: Demand basically means a consumer’s desire to buy goods and services without any hesitation and pay the price for it. In simple words, demand is the number of goods that the customers are ready and willing to buy at several prices during a given time frame. Preferences and choices are the basics of demand, and can be described in terms of the cost, benefits, profit, and other variables.The amount of goods that the customers pick, modestly relies on the cost of the commodity, the cost of other commodities, the customer’s earnings, and his or her tastes and proclivity. The amount of a commodity that a customer is ready to purchase, is able to manage and afford at provided prices of goods, and custom. There are many determinants of demand, but the top five determinants of demand are as follows:

3. Product cost: Demand of the product changes as per the change in the price of the commodity. People deciding to buy a product remain constant only if all the factors related to it remain unchanged.

4. Income of the consumers: When the income increases, the number of goods demanded also increases. Likewise, if the income decreases, the demand also decreases.

5. Costs of related goods and services: For a complimentary product, an increase in the cost of one commodity will decrease the demand for a complimentary product. Example: An increase in the rate of bread will decrease the demand for butter. Similarly, an increase in the rate of one commodity will generate the demand for a substitute product to increase. Example: Increase in the cost of tea will raise the demand for coffee and therefore, decrease the demand for tea.

6. Consumer expectation: High expectation of income or expectation in the increase in price of a good also leads to an increase in demand. Similarly, low expectation of income or low pricing of goods will decrease the demand.

7. Buyers in the market: If the number of buyers for a commodity are more or less, then there will be a shift in tastes and preferences of consumers is known as demand for the commodity.

8. Supply: It refers to the amount of a given product or service that suppliers are willing to offer to consumers at a given price level at a given period.When the price of a product is low, the supply is low. When the price of a product is high, the supply is high. This makes sense because companies are seeking profits in the market place. They are more likely to produce products with a higher price and likelihood of producing profits than not.The factors of supply for a given product or service is related to expectations of producers; government policies; production technology; random, natural or other factors; the number of production units; the price of inputs; the price of related goods or services; the price of the product or service and the prices of production factors.

9. Competitors: A competitor is a person, business, team, or organization that competes against you or your company. If somebody is trying to beat you in a race, that person is your competitor. In business, we call a close a competitor a rival. In other words, rivals are the same size and make similar products.

10. Suppliers: A supplier is an entity that supplies goods and services to another organization. This entity is part of the supply chain of a business, which may provide the bulk of the value contained within its products. Some suppliers may even engage in drop shipping, where they ship goods directly to the customers of the buyer.A supplier is usually a manufacturer or a distributor. A distributor buys goods from multiple manufacturers and sells them to its customers. For example: A shoe manufacturer buys components for its shoes from a group of suppliers. One supplier provides it with rubber heels, while another supplier provides it with tanned leather. A third supplier provides it with the buckles to be used on selected shoe models, while a fourth supplier provides the thread used to stitch shoes together.

11. Distribution chain: A supply chain is a network between a company and its suppliers to produce and distribute a specific product to the final buyer. This network includes different activities, people, entities, information, and resources. The supply chain also represents the steps it takes to get the product or service from its original state to the customer. Companies develop supply chains so they can reduce their costs and remain competitive in the business landscape. Supply Chain Management is a crucial process because an optimized supply chain results in lower costs and a faster production cycle.

II. Political environment: The different political considerations of the countries involved in the global business either facilitate or hinder the business. The trade agreements entered between the governments of countries are the ones that are the most affected by political stability, foreign trade regulations, change of actions of the new governments, and many more. In addition, doing businesses with countries that lack political stability will directly influence the operations of the MNCs. Political factors that affect Business Environment includes:

1. Political Stability: The political scenario of a country greatly impacts the operations of a business. If there is a lack of political stability, there are always disruptions, and uneven working patterns are observed. The government keeps on imposing restrictions in different sectors which in turn affects the business on a large scale.

2. Taxation and Economic Policies: The tax regime of a country directly impacts the operations of a business. The tax rates vary from business to business and activity to activity. Therefore, the role of government as a regulator here becomes very vital.The economic policies of the government like monetary policy controls the money supply in an economy which in turn affects the working capital requirements of the business on a day to day basis.Various components like fiscal policy, monetary policy, tax laws, rules and notifications are used by the government to affect the business activities directly and indirectly.

3. Foreign Trade Regulations: The expansionary policies of the management of the companies enable the firm to operate on a global scale where the role of the government comes into the picture. Government sets various rules and regulations (EXIM Policy, Forex Policy, etc.) to enable the firm to function in the international market and so as to keep up the competitiveness in the global market.The Government of India follows the model code of conduct based on UNCITRAL MODEL in order to resolve the disputes that occur while operating businesses globally. There are a huge variety of instruments available with the government with which it regulates the Business Environment. Many a time, the government itself starts producing economic goods like electricity and public transport services in order to keep control and check on the practices of the private players.

The government uses its taxation tools and subsidies in order to promote the production process. It provides subsidies and tax concessions for production of those goods that promote social welfare, and higher taxes may be imposed on goods like alcohol and cigarettes. Government frames and keeps on updating the labor laws of the country so as to keep a check on the injustices done to the working class. The Government of India has framed many regulations that keep strict vigilance on the activities like money laundering and investment of the companies in Tax Haven. Thus, the role of government and its policies play a very decisive role in the business environment of an economy. The policies of the government are either promotive or restrictive. In the case of promotive policies, the government brings out various schemes to promote small businesses and enterprises. It lowers down the interest on loans taken by small farmers, so as to boost the agriculture sector and small enterprises. In case of restrictive policies, the government imposes a ban on the practices of various players in the market, which may be detrimental to the society as a whole like a ban on plastic bags, etc.

III. Legal and professional environment: Legal environment constitutes the laws and various legislations passed in the parliament. The businessman cannot overlook the legislations because he has to perform his business transactions within the framework of legal environment.Some Aspects of Legal Environment:

1. Various laws and legislative acts.

2. Legal policies related to licensing.

3. Legal policies related to foreign trade.

4. Statutory warnings essential to be printed on label.

5. Foreign Exchange Regulation and Management Act.

6. Laws to keep a check on Advertisements.

The common legislation passed which has affected the business transactions are Trade Mark Act, Essential Commodity Act, Weights and Measures Act, etc. Most of the time legal environments put constraints on the businessman but sometimes they provide opportunities also. Every country has different laws and governing policies. A company should check all the legal requirements in the country in which it wants to conduct business. The basic laws that need attention are organization laws, securities laws, consumer protection laws, employee’s protection laws, and many more. The process can be lengthy but it is necessary.

Cross-country businesses have to deal with the legal framework of two or more countries. They may differ in terms of age, disability discrimination, wage rates, employment, environment, and others. Hence, it affects the working of the MNCs to abide by all the rules of all the countries. In addition, many international lending agencies could affect legal culture and working policies.

Common instances of Indian legal environment which have influenced business transactions recently are:

1. Advertisement of alcoholic product is prohibited.

2. Compulsory to give statutory warning in Tobacco production.

3. Delicensing policy of industries.

4. Deregulation of capital market has made it easy for businessman to collect capital from primary market.

5. Removal of control from the foreign exchange and liberalization in investment is encouraging foreign investors and NRIs to invest in Indian capital market.

It is important to understand that each country has its own culture, which affects international business in three main areas: organizational hierarchy, etiquette and communication. Japan, for instance, values social hierarchy in all aspects of life, including work. Scandinavian countries, on the other hand, have a relatively flat organizational hierarchy. Spain and other Mediterranean countries emphasize leisure time; Germany and Japan value efficiency and have strict workplace rules.Also, business professionals from different countries may view the purpose of negotiation or verbal agreement differently. For some, the goal of a contract is to create a relationship between the parties involved while for others, it's legally binding. Additionally, what's acceptable in one country may be considered offensive or fraudulent in another. As a business owner, it's important to consider these cultural aspects before you go global.

IV. Social and cultural environment: Social Environment consists of the customs and traditions of the society in which business is existing. It includes the standard of living, taste, preferences, and education level of the people living in the society where business exists.The social environment and culture, like the peoples' customs, lifestyles have a direct impact on international business. The social factors, like education, awareness, status, and trends of the people in society, determine the consumers' behavior for purchasing goods and services.

Some Aspects of Social Environment:

a. Attitude of customers towards innovation, lifestyle etc.
b. Birth and Death rates
c. Consumption habits
d. Education and literacy rates
e. Importance or place of women in workforce
f. Population
g. Quality of life
h. Tradition, customs, and habits of people etc.

In India also, there are many social reforms taking place and the common factors of Indian Social Environment are:

a. Demand for reservation in jobs for minority and women
b. Demand for equal status of women by paying equal wages for male and female workers
c. Demand for automatic machines and luxury items in middle class families
d. The social movements to improve the education level of girl child.
e. Health and Fitness trend has become popular.

V. Technological Environment:It refers to changes taking place in the method of production, use of new equipment and machineries to improve, the quality of product. The businessman must closely monitor the technological changes taking place in his industry because he will have to implement these changes to remain in the competitive market.Technological changes always bring quality improvement and more benefits for customers. Some Aspects of Technological Environment includes various Innovations and Inventions; Scientific Improvements; Developments in IT sector; Import and Export of Technology and Technological Advances in Computersetc.

The recent technological changes of Indian market are:

1. Color T.V. technology has closed the business of black and white T.V.

2. Artificial fabric has taken the market of traditional cotton and silk fabrics.

3. Digital watches have killed the prospects and the business of traditional watches.

4. From typewriter to World Processors.

5. Photo copier and Xerox machines have led to the closure of carbon paper business.

6. Shift in Demand from vacuum tubes to transistors.

7. Shift from steam locomotives its diesel and electric engine.

Summary

Business organization needs to interact and transact with its environment. Regardless of the type or size of a business, there is a close and continuous interaction between the business and its environment. Also, it is this interaction which helps strengthen the firm and use its resources effectively. It will reduce the profit margin and will make the opportunities for expansion to slip. Business environmentrefers to those aspects of the surroundings business enterprise, which affect or influence itsoperations and determine its effectiveness. The business environment is dynamic and is uncertain. It is because of vitality ofenvironment. In simple words, business environment is the sum of all the factorsoutside the control of management of a company. These factors are constantly changing, andthey carry with them both opportunities and risks or uncertainties decide thefuture of business.It encompasses all those factors that affect a company's operations andincludes customers, competitors, stakeholders, suppliers, industry trends, regulations othergovernment activities, social and economic factors and technological developments. Thus,business environment refers to the external environment and includes all factors outside the firm,which lead to opportunities and threats of a firm. Aproper appreciation of the environmental factors will bring many benefits to the business entities worldwide.Thus, the multinational corporations must obtain necessary information on all environment dimensions and get adapted to it. It must identify vulnerable areas and should look forward to a better environment and execution of best practices.Failure to understand the environmental factors for business shall create number of problems, which in fact are difficult to solve.

Keywords

1. Interest rates: The interest rate is the amount a lender charges a borrower and is a percentage of the principal—the amount loaned.

2. Taxes: A tax is a mandatory fee or financial charge levied by any government on an individual or an organization to collect revenue for public works providing the best facilities and infrastructure. The collected fund is then used to fund different public expenditure programs

3. Inflation: Inflation is a measure of the rate of rising prices of goods and services in an economy. Inflation can occur when prices rise due to increases in production costs, such as raw materials and wages.

4. Currency exchange rates: Exchange rate is the price of one currency in terms of another currency.

5. Consumer discretionary income: This can basically be defined as any income remaining after all essential expenses have been paid.

6. Savings rates: The savings rate is a measure of the amount of money which an individual deducts from his/her disposable personal income to keep aside as a nest egg or for retirement, expressed as a percentage or ratio.

7. Recession: A sustained period of weak or negative growth in real GDP (output) that is accompanied by a significant rise in the unemployment rate is better known as Recession.

8. Market size: It is the maximum total number of sales or customers your business can see, often measured over the course of a year.

9. Demand: Demand basically means a consumer's desire to buy goods and services without any hesitation and pay the price for it.

10. Product cost: Demand of the product changes as per the change in the price of the commodity. People deciding to buy a product remain constant only if all the factors related to it remain unchanged.

11. Income of the consumers: When the income increases, the number of goods demanded also increases. Likewise, if the income decreases, the demand also decreases.

12. Costs of related goods and services: For a complimentary product, an increase in the cost of one commodity will decrease the demand for a complimentary product.

13. Consumer expectation: High expectation of income or expectation in the increase in price of a good also leads to an increase in demand. Similarly, low expectation of income or low pricing of goods will decrease the demand.

14. Buyers in the market: If the number of buyers for a commodity are more or less, then there will be a shift in tastes and preferences of consumers is known as demand for the commodity.

15. Supply: It refers to the amount of a given product or service that suppliers are willing to offer to consumers at a given price level at a given period. When the price of a product is low, the supply is low. When the price of a product is high, the supply is high. This makes sense because companies are seeking profits in the market place

16. Competitors: A competitor is a person, business, team, or organization that competes against you or your company. If somebody is trying to beat you in a race, that person is your competitor. In business, we call a close a competitor a rival. In other words, rivals are the same size and make similar products.

17. Suppliers: A supplier is an entity that supplies goods and services to another organization. This entity is part of the supply chain of a business, which may provide the bulk of the value contained within its products.

18. Distribution chain: A supply chain is a network between a company and its suppliers to produce and distribute a specific product to the final buyer. This network includes different activities, people, entities, information, and resources.

SelfAssessment

1. A business entity can get affected by _________________

A. Local and regional factors only

B. Regional and national factors only

C. Internal and external factors

D. Financial and non-financial factors only

2. Economic environment refers to all forces which have a _______impact on business

A. Political

B. Natural

C. Social

D. Economic

3. ________ environment is beyond the control of the business

A. External

B. Internal

C. Micro

D. Macro

4. _____ Environment can be defined as that part of the environment that isconcerned with the entire social system.

A. General environment

B. Social environment

C. Operating environment

D. Political environment

5. The purchasing power of money varies ______.

A. Directly with the volume of employment

B. Directly with the interest rate

C. Directly with the price level

D. Inversely with the price level

6. When prices are falling continuously, the phenomena is known as______

A. Reflation

B. Stagflation

C. Deflation

D. Reflation

7. Inflation is measured on basis of:
A. Both wholesale price index as well as consumer price index
B. Either wholesale price index or consumer price index
C. Wholesale Price Index
D. Consumer Price Index

8. Inflation always_____
A. reduces the purchasing power of a Rupee
B. reduces the cost of living
C. reduces the standard of living
D. reduces the price of products

9. When the price of India's' currency is expressed in terms of Sri Lankan Currency, it is known as:
A. Flexible rate of return
B. Foreign exchange rate
C. Current rate of exchange
D. None of these

10. Decrease in currency of a countryleads to_______
A. Rise in Imports
B. No change
C. Decrease in Imports as well as Exports
D. Rise in Exports

11. Decrease in value of currency in a country in relation to foreign currency due to fluctuations in foreign exchange is better known as:
A. Appreciation
B. Inflation
C. Depreciation
D. Degradation

12. When exchange rate in terms of domestic currency rises:-
A. Imports become cheaper
B. Exports become cheaper
C. Exports become costlier
D. NO effect on imports

13. In the foreign exchange markets that market price of US Dollar rises from 60 to 61. This means that:
A. There is depreciation in Rupee

B. The US Dollar has appreciated

C. Both a) and b)

D. None of the above

14. The rate determined by the government is known as: -

A. Fixed Exchange Rate

B. Flexible exchange rate

C. Floating exchange rate

D. None of these

15. If 120 are required to buy $ 1, instead of 100 earlier: -

A. Rupee value of import bill shall increase

B. Domestic currency has appreciated

C. Domestic currency has depreciated

D. Both A) and C

Answers forSelf Assessment

1.	C	2.	D	3.	A	4.	B	5.	D
6.	C	7.	D	8.	A	9.	B	10.	D
11.	C	12.	B	13.	C	14.	A	15.	D

Review Questions

1. Discuss the macro economic factors affecting the international business environment.
2. Discuss the micro economic factors that affect the international business environment.
3. How politics of a country impact the international business environment?
4. How taxation and economic policies and foreign trade regulations impact the international business environment?
5. How Technological and socio-culturalfactors impact the international business environment?

Further Readings

- International Accounting by Das Mahopatra, Prentice Hall
- International Accounting by Rathore, Shirin, Prentice Hall

Web Links

- https://keydifferences.com/difference-between-domestic-and-international-business.html
- https://www.britannica.com/topic/exchange-rate
- https://www.britannica.com/topic/unemployment-rate
- https://efinancemanagement.com/international-financial-management/international-business
- https://byjusexamprep.com/study-notes-on-role-of-political-environment-i

- https://www.yourarticlelibrary.com/business-environment/5-major-components-of-business-environment-business-studies/8638

Unit 03: Transnational Reporting

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the need for International Financial reporting
- Outline the complexities in International Financial reporting
- Classify the reporting practices and financial accounting
- understand the transnational practices classification.

Introduction

The financial crisis and worldwide recession in 2008 halted the expansion of global capital and banking markets. However, as economic recovery picked up cross-border capital flows, which stood as US$1.6 trillion in 2009, reached US$4.4 trillion in 2010. The trend continued and cross-border holdings of securities reached $46.2 trillion by the end of December 2015 (IMF coordinate portfolio Investment Survey 2015).In 2016 global flows of foreign direct investment fell about two per cent to $1.75 trillion. Investment in developing countries declined even more, by 14 per cent and flows to LCDs and structurally weak economies remained volatile and low. Although United Nations Conference on Trade and Development (UNCTAD) predicted a modest recovery of FDI flows in 2017-18, they are expected to remain below their 2007 peak.These developments are considered to the troublesome, especially considering the enormous investment needs associated with the sustainable goals in SDGS. Capital needs of countries are also no longer met domestically and a number of companies have resorted to trotting the globe to peddle their securities. Investors, on the other hand, have also transcended national boundaries to pour money into foreign securities.Investors, on the other hand, have also transcended national boundaries to pour direct investment recovery was strong in 2015. Global FDI flows jumped by 38 per cent to $76 trillion (World Investment Report, 2016). All this gave rise to the need for transnational financial reporting. Another significant development has been the increase in cross-border listings, requiring the listed companies to prepare their financial statements according to the standards and practices of the country where the securities are listed. In this lecture we will discuss a brief introduction to Transnational Reporting and what all complexities are involved for the same.

Meaning of Transnational Reporting

- It is a complex and multi-faceted process that demands professionalism and high levels of liability by accounting professionals.Financial reporting involves the publication of financial statements (profit and loss account, balance sheet, etc.) together with supplementary material such as notes, a management report and a report by independent auditors. Developments such as that of the Single European Market and, more generally, the internationalization of financial markets, have led to an increasing tendency for large European business organizations to undertake what may be termed 'transnational financial reporting', using one or more languages in addition to the language of the original report.
- The expanding horizon of business activity in recent years particularly as a consequence of opening up of economies has resulted in expansion in world trade, rapid growth in international capital markets, a surge in cross-border mergers and acquisitions and predominance of multinational corporations in the international business scenario.
- This accelerating globalization of world markets holds profound implications for accounting practices and policies also. The quantum of foreign direct investments (FDI) has not only soared in the past few years, but its nature and directions have also changed.
- FDI is no longer one-way traffic, even the former importers of capital, that is, the developing countries have outflows of capital now.
- In other words, in this competitive environment it is important not only to attract foreign investors but also to retain them.
- Consequently, the need to report to existing and potential investors in different countries has led to the evolution of transnational reporting and the complexities with regard to the same.
- Besides, companies entering foreign markets for customers and capital also list their securities on foreign stock exchanges.
- This enhances the credibility of the firm and also improves the marketability of the securities. Stock exchanges, however, have their own rules and regulations with regard to listing of securities which have to be compiled with.
- Submission of financial statements as per the requirements of the country in which the stock exchange is located is generally one of the provisions which have to be compiled with.
- For instance, the Securities Exchange Commission rules require foreign companies listed in the US to comply with the information requirements set forth in Form 20F.

Use of SEC form 20-F?

- Well, it is a form issued by the Securities and Exchange Commission (SEC) that must be submitted by all "foreign private issuers" with listed equity shares on exchanges in the U.S. Form 20-F calls for the submission of an annual report within four months of the end of a company's fiscal year or if the fiscal year-end date changes.
- The reporting and eligibility requirements for Form 20-F are stated in the Securities Exchange Act of 1934.
- Accordingly, financial statements furnished by foreign private issuers disclose essentially equivalent information to statements complying with US GAAP.
- The information needs of foreign investors are different from domestic users in the sense that they require the financial information which is comprehensible to them.
- In other Words, it should be presented in a language they understand, in their Currency, according to the accounting principles comprehensible to them, and authenticated as per auditing standards they can place their confidence in.
- All this gives rise to the problems of international financial reporting. Financial globalization can thus be considered to be the Primary factor responsible for the origin of transnational reporting.

- As Choi and Bavishi (1983) observe, "Whenever investors who are removed from the local scene have to read and interpret financial statements prepared according to local accounting norms, an international Reporting problem can arise."
- Thus, as firms seek global markets for capital, accounting practitioners must wrestle with cross-border differences in language, reporting currencies, accounting conventions, disclosure requirements and auditing standards.

Factors That Makes the Task of Transnational Reporting

Language and Currency Barrier

Language and Currency Barrier

- Both of these factors makes the work of transnational reporting really tedious and complex.
- Well, an enterprise would generally prepare its financial statements in the language, script and currency of the country in which it is situated, or the language commonly prevalent in that country.
- For instance, companies in India prepare their financial statements in English. Similarly, financial statements prepared in Japan would, by and large, be in the Japanese script and language.
- Consequently, few Indian users would be in a position to comprehend their key elements unless they were translated into English or Hindi. Similarly, the case with Japanese audience.
- If an Indian company wants to be enlisted on NASDAQ or the New York Stock Exchange, it must prepare its financial statements in English.
- Besides language, the currency in which the financial statements are prepared poses a problem as well—probably of a greater dimension. For instance, financial statements prepared in India would obviously be in Rupees, whereas, the Japanese investor would be interested in knowing the profitability and worth of the company in Japanese Yens.
- Similarly, the British investor would like to assess the performance of the company in pounds, and so on. It is extremely difficult for the Indian company to translate its financial statements into different currencies to suit the needs of all its foreign investors.
- However, some MNCs do add a column in their financial statements, wherein they indicate the values particular foreign currency at the current rate of exchange.
- This practice is termed as translation for convenience. Such translation in multiple currencies would, however, prove to be a costly and time-consuming exercise for the MNCs.

Balance Sheet of Toyota in Yen and Dollars

	Yen in Millions	US dollars in millions	
Liabilities and Shareholders' Equity	2012	2013	2013
Current liabilities			
Short-term borrowings	¥ 3450649	¥ 4,089,528	$43,482

Current portion of long-term debt	25,12,620	27,04,428.00	28,755
Accounts payable	22,42,583	21,13,778.00	22,475
Other payables	6,29,093	7,21,065	7,667
Accrued expenses	18,28,523	21,85,537	23,238
Income taxes payable	1,33,778	1,56,266	1,662
Other current liabilities	984328	941918	10,015
Total current liabilities	83,30,925	1,29,12,520	1,37,294
Long-term liabilities			
Long-term debt	60,42,277	73,37,824	78,020
Accrued pension and severance costs	7,08,402	7,66,112	8,146
Deferred income taxes	9,08,883	13,85,927	14,736
Other long-term liabilities	143351	3,08,078	3,276
Total long-term liabilities	78,02,913	97,97,941	1,04,178

Shareholders; Equity

Shareholders' equity			
Toyota Motor Corporation shareholders' equity Common stock. no par value, authorized: 10.000.000.000 shares in 2012 and 2013 issued: 3,447,997.492 shares in 2012 and 2013	3,97,050	3,97,050	4,222
Additional paid-in capital	5,50,650	5,51,040	5,859
Retained earnings	1,19,17,074	1,26,89,206	1,34,920
Accumulated other comprehensive income (loss)	-11,78,833	-3,56,123	-3,787
Treasury stock, at cost, 28 1,187,739 shares in 2012	-11,35,680	-11,33,138	-12,048

Total Toyota Motor Corporation shareholders' equity	1,05,50,261	1,21,48,035	1,29,166
Noncontrolling interests	5,16,217	6,24,821	6,643
Total shareholders · equity	1,10,66,478	1,27,72,856	1,35,809
Commitments and contingencies			
Total liabilities and shareholders' equity	¥30,650,965	¥35483317	$377,281
Additional paid-in capital	5,50,650	5,51,040	5,859
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Income Statement of Toyota

	Yen in millions			U.S. dollars in millions
	2011	2012	2013	2013
Net revenues Sales of products	¥ 17,820,520	¥ 17,5 11 ,916	¥2,09,14,150	$2,22,373

Financing operations	11,73,168	1,071.74	1.150.042	12.228
Total net revenues	1,89,93,688	1,85,83,653	2,20,64,192	2,34,601
Costs and Expenses				
Cost of products sold	1,59,85,783	1,57,95,918	18,010.57	1,91,500
Cost of financing operations	6,29,543	5,92,646	6,30,426	6,703
Selling, general and administrative	19,10,083	18,39,462	21,02,309	22,353
Total costs and expenses	1,85,25,409	1,82,28,026	2,07,43,304	2,20,556
Operating income	4,68,279	3,55,627	1,320.89	14,045
Other income (expense)				
Interest and dividend income	90,771	99,865	98,673	1,049
Interest expense	-29,318	-22,922	-22,967	-244
Foreign exchange gain, net	14,305	37,105	5,55 1	59
Other income (loss), net	19,253	-36,802	1,504	16
Total other income (expense)	95,011	77,246	82,761	880
Income before income taxes and equity in earnings of affiliated companies	5,63,290	4,32,873	14,03,649	14,925
Provision for income taxes	3,12,821	2,62,272	5,51,686	5.866
Equity in earnings of affiliated companies	2,15,016	1,97,701	23 1,519	2,461
Net income	4,65,485	3,68,302	1.083482	11.52
Less: Net income attributable to	-57.302	-84.743	-121.3 19	-1.29
Non-controlling	¥4,08,183	¥2,83,559	¥962. 163	$10.230

interests				
Net income attributable to TMC				
Yen U.S. dollars	¥130.17	¥90.21	¥303.82	$3.23
Net income attributable to				
Toyota Motor Corporation per share				
- Basic				
- Diluted	¥130.16	¥90.20	¥303.78	$3.23
Cash dividends per share	¥50.00	¥50.00	¥90.00	$0.96

II. Accounting Policies and Standards

- A more complicated problem encountered by a company while preparing its financial statements, in accordance with the requirements of another country is the significant difference in accounting principles.
- It is important to note that :
    - Firstly, the differences may be conceptual or with regard to income determination or asset valuation, etc.
    - Secondly, the diversity prevalent in accounting principles and practices makes comparison of financial statements difficult.
- For instance, in India, the Companies Act 2013 clearly provides that financial statement in relation to a company, includes:
    - a balance sheet as at the end of the financial year;
    - a profit and loss account, or in case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
    - cash flow statement for the financial year.
    - a statement of changes in equity, if applicable and lastly.
    - any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv) Section 1(40).
- An investor in the US would, therefore, not find a statement of comprehensive income in the financial statements prepared by an Indian company as it is not required as per the relevant provisions in India.
- Similarly, there is no requirement for disclosure of critical judgment made by the management in applying accounting policies, or key sources of estimation of uncertainty at the end of the reporting period.
- To retain such investors the company would have to include these statements.

- Examples of differences that influence income determination include provisions with regard to inventory valuation, asset revaluation, amortization of intangibles, etc.
- For instance, when assigning the cost of interchangeable inventories, the use of either first in, first out, or weighted average formula is permitted by the International Financial Reporting Standards (IFRS).
- However, the US and Canada also Permit the use of the Last-in First-out (LIFO) which can have a considerable impact on reported profits in inflationary environments.
- Again, even though similar concepts may be prevalent contiguous countries or a group of countries, it is practically impossible to find two countries with identical accounting practices.
- This situation imposes a big financial burden on the MNC reporting its performance to foreign audiences-of-interest.
- Thus, it is rightly quoted by Bruyne in year 1980 that Financial information is a form of language….. Unless the language is intelligible, no benefit can be derived from it.
- And, if the language of financial information is to be put to use so that investment and credit decision can more readily be taken, it should not only be ineligible, but should also be comparable.

III. Disclosure Requirements

- Disclosure of financial information is an essential ingredient of a properly-functioning capital market. Consequently, a prominent feature of reporting regulations over the past two decades has been an explosion in the volume of the required financial disclosure.
- Increased corporate disclosure is said to provide the investors with a basis on which to judge a security. It improves the subjective probability distribution of the expected return from a security and reduces the Risk associated with the return stream.
- Thus, it is in the interest of corporations turning to global capital markets for finance to make adequate disclosure to assist the investors in taking a decision to part with their money.
- Expanded disclosure is also instrumental in reducing the cost of capital since it helps to reduce the risk associated with the return.
- Besides shareholders and creditors, the demand for more disclosure by MNCs is made by labour unions (who are interested in the security and welfare of the employees), the host country governments of the developing countries (who
- tend to see the multinational as a direct challenge to their national activities), and the public at large which is concerned about the adverse environmental and social effect of the corporations' operations.
- The demand for expanded disclosure by MNCs has, however, not been received favourably in all quarters. The MNCs feel that while such disclosures would not enhance the utility of the financial statements, they would on the one hand increase their cost and, on the other, hurt their competitive position.

Classification of Reporting Practices and Financial Accounting

- Translations for convenience
- Dual Financial reporting
- Limited restatements
- Supplemental Information

1. Translation

- Keeping with nationalistic and regulatory considerations, companies, by and large, prepare their annual accounts in the language and currency of the country of domicile, and the reporting is also done in the same manner. However, for the convenience of foreign investors, they may translate the financial statements.
- Translation may be of two types
    - Language-translated reports and accounts.
    - Language-and currency-translated reports and accounts.

A) Language-translated Reports and Accounts

The first approach of translating only the language of the financial statements is adopted by a host of companies domiciled in non-English speaking countries.

- To mention a few, Infosys in India, Alfa-Laval in Sweden, The Olivetti Group in Italy, Daimler-Benz in Germany, the CPR Group in France, and AKER in Norway.
- It must be mentioned here that under this approach, it is the language only which is translated; the currency, accounting principles etc., continue to be those of the company's country of domicile.

B) Language-and Currency-translated Reports and Accounts

This approach is an improvement over the first, as, under it, the language-translated financial statements contain adjacent to the column in the domestic currency, an additional column for figures translated in a foreign currency at the current rate of foreign exchange (forex).

- This is done for the convenience of the foreign investors in the belief that this is what they would do if they were given a language-translated only primary financial statement of the company's country of domicile. The currency-translated figures are generally only for the current year.

Extracts from the annual report of OKI Electric, a Japanese company, for the year 2012 and 2013.

	Millions of Yen		Thousands of US dollars (Note 2)
ASSETS	2013	2012	2013
Current assets:			
Cash and cash equivalents (Notes 3 and 7)	¥35,894	¥74,996	$385,956
Time Deposits (Note 7)	10	13	107
Securities (Notes 3 and 7)	502	4,504	5,397
Notes and accounts receivable:			

Unconsolidated subsidiaries and affiliates	2,052	3,091	22,064
Other	1,31,770	1,25,103	14,16,881
Less: Allowance for doubtful receivables	-7,600	-12,325	-81,720
Inventories (Note 4)	74,963	68,227	8,06,053
Other current assets (Note 9)	9,401	10,279	1,01,086
Total current assets	2,46,994	2,73,888	26,55,849
Investments and long-term receivables:			
Investments in and advances to unconsolidated	4,878	6,242	52,451
subsidiaries and affiliates (Notes 5 and 7)			
Other investments in securities (Notes 3. 6 and 7)	23,829	21,033	2,56,225
Other long-term receivables	866	930	9,311
Less allowance for doubtful receivables	-936	-1,175	-10,064
Total investments and long-term receivables	28,638	27,031	3,07,935
Property, plant, and equipment, at cost (Notes 6):			
Land	12,343	12,042	1,32,720
Buildings	78,064	74,538	8,39,397
Machinery and equipment	1,17,800	1,11,164	12,66,666
Construction in progress	1,629	1,189	17,516
	2,09,838	1,98,934	22,56,322

Less: Accumulated depreciation	-1,52,008	-1,46,342	-16,34,494
Property, plant and equipment, net	57,829	52,592	6,21,817
Other assets (Note 9)	15,861	14,552	1,70,548
Total assets	¥3,49,322	¥3,68,065	$37,56,150
LIABILITIES			
Current liabilities:			
Short-term borrowings (Notes 6 and 7)	¥56,371	¥53,837	$606,139
Current portion of long-term debt (Notes 6 and 7)	18,821	22,797	2,02,376
Notes and accounts payable:			
Unconsolidated subsidiaries and affiliates	897	2,671	9,645
Other	74,448	78,009	8,00,516
Other accrued expenses	33,688	31,608	3,62,236
Other current liabilities (Note 9)	12,902	25,430	1,38,731
Total current liabilities	1,97,129	2,14,355	21,19,666
Long-term liabilities			
Long-term debt (Notes 6 and 7)	45,332	59,843	4,87,440
Retirement benefits (Note 8)	20,209	19,207	2,17,301
Other long-term liabilities (Notes 7 and 9)	30,025	33,407	3,22,849
Total long-term liabilities	95,567	1,12,457	10,27,602
Total liabilities	2,92,697	3,26,813	31,47,279

Net Assets			
Shareholders' equity (Notes 10 and 18):			
Capital stock: Authorized-2,400,000,000 shares Issued Common Stock-731,438,670 shares in 2013 and 2012 Class A Preferred Stock			
Issued-30,000 shares in 2013 and 2012	44,000	44,000	4,73,118
Additional paid in-capital	21,554	21,554	2,31,763
Accumulated deficit	-7,788	-20,968	-83,741
Less: Treasury stock, at cost:			
3,465,556 shares in 2013 and 612,141 shares in 2012	-399	-38	-4,290
Total shareholders' equity	57,366	44,547	6,16,838
Accumulated other comprehensive income			
Net unrealized holdings gain (loss) on other securities	2,192	-1,815	23,569
Loss on deferred hedges	-656	-973	-7,053
Translation adjustments	-2,829	-632	-30,419
Total Accumulated other comprehensive income	-1,293	-3,422	-13,903
Subscription rights to shares	79	79	849
Minority interests in consolidated subsidiaries	473	46	5,086
Total net assets	56,625	41,251	6,08,870
Contingent liabilities (Note 17)			

Total liabilities and net assets	¥349,322	¥368,065	$3,756,150

It is seen be clearly seen that the company gives US dollar-translated values in the company's balance sheet, which helpful for the stakeholders globally.

2. Dual Financial Reporting

This approach was recommended by the Accountants' International Study Group (1975) in the early 1970s. It entails the preparation of two (a primary and a secondary) sets of financial statements by the companies.

Primary financial statements are based on the accounting and reporting standards of the company's country of domicile, expressed in the language and currency of that country.

Secondary statements, on the other hand, are statements prepared specifically for audiences-of - interest in foreign countries, having one or more of the following characteristics:

1. They are based on the accounting and reporting standards of another country;
2. They are translated into a foreign currency.
3. They are translated into the language other than a language of the reporting company's country of domicile.
4. The independent auditor's report on the financial statements is expressed in a form not commonly used in the reporting company's country of domicile.

Such secondary statements would, however, not be necessary for situations where the primary statements contain information adequate to the needs of foreign users.

For instance, Infosys in India prepares unaudited financial statements in substantial requirements with GAAP requirements of Australia, Canada, France, Germany, Japan, and the UK. In case of France, it is in French;

for Germany, it is in German, and in Japanese for Japan. Even the currency is that of the concerned country. For Australia, Canada, and the UK, it is in English.

3. Limited Restatements

Quite a few companies adopt this practice and restate or adjust the income figures according to the GAAP in another country to which the foreign audiences-of-interests belong. For instance, Infosys India not only reconciled the net income/loss as per GAAP in the US but also explained the significant differences. There are differences between the US GAAP and the Indian GAAP financial statements.

Reconciliation of Indian and US GAAP Financial Statements

Year ended 31st March	2008	2009
Indian GAAP – Standalone	4,470	3,783
Profits of subsidiary companies	189	83
Minority Interest	----	(10)

Indian GAAP-Consolidated	4,659	3,856
Amortization of Intangibles	(29)	(17)
Fringe Benefit Tax	(2)	----
Stock compensation expenses	(13)	(24)
US GAAP net income	4,615	3,815
US GAAP net income (US million)	1,155	850

Important concerns

There are certain concerns that must be tackled properly. These are discussed below:

a) Amortization of intangibles:

The US GAAP requires the purchase price in business combination transactions to be allocated to identifiable assets and liabilities, including intangible assets; Intangible assets are to be amortized over the estimated useful life.

- The amortization relates to that of an intangible asset identified in the allocation of the purchase price of Infosys BPO Limited and Pan Financial Shared Services.
- Stock compensation expenses: US GAAP requires upon adoption of SFAS 1230, effective from April 1, 2007, stock compensation expenses 10 be recorded based on the grant date fair value of the option over its vesting term.
- The fair value of a stock option is determined using an option-pricing model that considers the stock price at the grant date, the 'exercise price, the expected life of the option, the volatility of the underlying stock and the 'expected dividends on it, and the risk-free interest rate over the expected life of the option

.

b) Fringe benefit tax (FBT)

US GAAP requires the payment of FBT to be accounted as an expense while at the same time accounting for the recovery from the employee as an adjustment to the exercise price and hence credit to equity. Whereas, under the Indian GAAP, the recovery is credited to the profit and loss account.

c) Related party transactions

A related-party transaction is an arrangement between two parties that have a preexisting business relationship.

Some, but not all, related party-transactions carry the innate potential for conflicts of interest, so regulatory agencies scrutinize them carefully.

Unchecked, the misuse of related-party transactions could result in fraud and financial ruin for all parties involved.

American regulatory bodies ensure that related-party transactions are conflict-free and do not affect shareholders' value or the corporation's profits negatively.

These have been discussed in detail in the notes to the Indian GAAP financial statements in this report events occurring after balance sheet date. Interestingly, no significant events occurring after the balance sheet date were found.

Source: Infosys Annual Report 2007, 2007-08, p. 58.

- These reconciliation statements are no longer required by the SEC of the US, which in November 2007 agreed to drop the requirement for reconciliation to US GAAP for foreign registrants such as Infosys that prepared their financial statements using IFRS or equivalent standards;
- details of the reasons which pressurized the SEC to do so have already been dealt with in the section relating to 'National regulatory requirements' dealt with earlier.

This example is meant to explain this reporting practice. With the increased adoption of IFRS, the annual report for the year 2015-16 mentions. The year at a glance, as per the Indian GAAP and as per IFRS for both 'standalone financial statements' and 'consolidated statements'.

4. Supplemental Information

Under this practice, companies provide the users of the financial statements with additional information which may assist them in understanding the basis according to which the financial statements have been prepared; Swedish companies enclosed along with the financial statements a booklet on understanding Swedish Financial Statements to enable Foreign audiences-of-interest to understand the financial statements with the help of the information given in the booklet.

- However, with the advancement in technology, the annual reports are available on the websites of most companies; in fact, it is a statutory requirement in many countries, the UK being one such example (see the section on National Regulatory Requirements for more details).

5. Appraisal of the Different Practices

The convenience translation approach does not involve much effort on the part of those who prepare the financial statements, and at the same time, it makes them intelligible to the users as far as the language is concerned.

Currency-translated financial statements have the edge over the only language-translated statements from the point of view of the users.

They are, however, likely to mislead the users with regard to the basis on which they have been prepared, particularly in the case of currency translations.

This shortcoming can be overcome by appending a note to the financial statements, specifying the rates at which the currency translations have been affected, and the fact that the translation of currency does not reflect the adoption of the GAAP of that country.

Though dual financial statements impose a financial burden on the MNCs, the practice would certainly improve the quality of the statements as they would cater to specific audiences of interest.

As Choi and Mueller (1992) rightly opine, specific recognition of reader audiences for primary and secondary reports should increase the information content (and therefore quality) of both types of financial statements no doubt, ………

providing the foreign investors with an earning figure Which facilitates comparison of the performance of the enterprise with that of other domestic enterprises.

Such an exercise, however, involves considerable cost and effort on the part of the reporting company and can, therefore, be undertaken only for investors in a specific country and when the investment is substantial, providing the users with additional information to enable them to.....

understand the financial statements is a laudable practice as all portfolio investors are generally not conversant with all, the national accounting standards and considerable effort has to be put in by the foreign users to understand the statements and quantitatively reconcile the differences, particularly if they lack technical expertise necessary for the purpose.

Of the four practices, the limited restatements of financial are perhaps the most effective from the point-of-view of the users, but as stated earlier, it would be possible to use this method only in respect of a limited number of countries.

Despite their limitations, all the approaches do add some value to the foreign financial statements for the foreign reader as compared to Primary financial statements prepared in the language, currency, and according to the accounting practices of the country of the reporting company.

The ultimate solution would lie in the more effective application of IASs, leading to uniform practices.

So, these were the transnational reporting practices classification.

Summary

In the context of multinational enterprises, accounting issues arise. Problems also include aspects relating to accounting for variable exchange rates, such as not only transaction accounting but also translation of international financial reports. They also embrace financial statement consolidation, which requires the elimination of intercompany transactions in a multi-currency setting. Accounting difficulties must be solved in a practical manner. Managers should be concerned about exchange rate swings as well.Again, their issues are in the future. Historical exchange rates do not serve the goal of converting current carrying amounts of assets and liabilities denominated in foreign currencies, which causes complications for accountants. Transactions with a certain settlement create no significant issues. However, non-settlement transactions necessitate translation methods that are far from universally accepted by managers or accountants.

Keywords

- Form 20-F: It requires comprehensive disclosure about the company, including information about its business operations and its financial statements.
- Foreign currency translation: It is the accounting procedure by which an international company converts the results of its foreign subsidiaries into domestic currency terms in order to record them in the books of account.
- Dual reporting—Dual reporting is the process of building accounting systems to be compliant with various reporting bases.

Self Assessment

1. Which of the following statements is wrong about Translation concept?

A. For the convenience of foreign investors, they may translate the financial statements.
B. There can be Language-translated reports
C. There can be Language-and currency-translated reports and accounts.
D. Language-translated reports is adopted by a host of companies domiciled in English speaking countries.

2. Under Language-translated Reports and Accounts:

A. it is the language only which is translated
B. it is the currency which is translated
C. it is the language and currency which are translated
D. None of these

3. Under Language-translated Reports and Accounts:

A. accounting principles etc., continue to be those of the company's country of domicile.

B. accounting principles etc., continue to be those of the other than company's country of domicile.

C. accounting principles etc., continue to be those of USA

D. accounting principles etc., continue to be those of India

4. Under Language-and Currency-translated Reports and Accounts:

A. The currency-translated figures are generally only for the current year.

B. The currency-translated figures are generally only for the previous year.

C. The currency-translated figures are generally only for the upcoming year.

D. None of these

5. Which approach was recommended by the Accountants' International Study Group (1975) in the early 1970s.

A. Translation

B. Dual Reporting

C. Restatements

D. Supplementary information

6. Under Dual Financial Reporting :

A. Primary financial statements are based on the accounting and reporting standards of the company's country of domicile

B. Primary financial statements are based on the accounting and reporting standards of the company's country of other than domicile

C. Primary financial statements are based on the accounting and reporting standards of the company's country of domicile, expressed in the language and currency of other than domicile country.

D. None of these

7. Under Dual Financial Reporting:

A. Secondary statements, are statements prepared specifically for audiences-of -interest in foreign countries

B. Secondary statements are based on the accounting and reporting standards of domicile country

C. They are not translated into a foreign currency

D. They are not translated into the language other than a language of the reporting company's country of domicile.

8. Under……companies restate or adjust the income figures according to the GAAP in another country to which the foreign audiences-of-interests belong.

A. Limited Restatements

B. Dual Financial Reporting

C. Translation

D. Supplementary information

9. Which of the following is true under Stock compensation expenses:
A. US GAAP requires upon adoption of SFAS 1230, effective from April 1, 2000
B. US GAAP requires upon adoption of SFAS 1230, effective from April 1, 1999
C. US GAAP requires stock compensation expenses to be recorded based on the grant date fair value of the option over its vesting term.
D. US GAAP requires stock compensation expenses to be recorded based on the grant date book value of the option over its vesting term.

10. Which of the following is false under FBT?
A. US GAAP requires the payment of FBT to be accounted as an expense
B. US GAAP requires accounting for the recovery from the employee as an adjustment to the exercise price and hence credit to equity.
C. under the Indian GAAP, the recovery is credited to the profit and loss account.
D. under the Indian GAAP, the recovery is debited to the profit and loss account.

11. Under this practice, companies provide the users of the financial statements with additional information which may assist them in understanding the basis according to which the financial statements have been prepared
A. Limited Restatements
B. Dual Financial Reporting
C. Translation
D. Supplementary information

12. It involves appending a note to the financial statements, specifying the rates at which the currency translations have been affected, and the fact that the translation of currency does not reflect the adoption of the GAAP of that country.
A. Appraisal of the Different Practices
B. Dual Financial Reporting
C. Translation
D. Supplementary information

13. Such an exercise, however, involves considerable cost and effort on the part of the reporting company and can, therefore, be undertaken only for investors in a specific country and when the investment is substantial:
A. Appraisal of the Different Practices
B. Dual Financial Reporting
C. Translation
D. Supplementary information

14. Infosys in India prepares unaudited financial statements in substantial requirements with GAAP requirements of Australia, Canada, France, Germany, Japan, and the UK. It is a case of
A. Appraisal of the Different Practices
B. Dual Financial Reporting
C. Translation

D. Supplementary information

15. Which of the following is wrong in regard to Intangible Assets:

A. The US GAAP requires the purchase price in business combination transactions to be allocated to identifiable assets and liabilities, including intangible assets;

B. Intangible assets are to be amortized over the estimated useful life.

C. The amortization relates to that of an intangible asset identified in the allocation of the purchase price of

D. Intangible assets are to be amortized over the already used life.

Answers for Self Assessment

1.	D	2.	A	3.	A	4.	A	5.	B
6.	A	7.	A	8.	A	9.	C	10.	D
11.	D	12.	A	13.	A	14.	B	15.	D

Review Questions

1) In which cases is translation modification required?
2) What is the difference between restatement and translation?
3) What are the two most significant challenges concerning the translation of foreign currency financial statements?
4) What is dual reporting accounting?
5) What is the use of supplementary information?

Further Readings

A text book on International Accounting and Reporting Issues: 2018 Review by United Nations Conference on Trade and Development (UNCTAD) · 2019

A text book on Dual Reporting for Equity and Other Comprehensive Income by Francesco Bellandi

Web Links

https://unctad.org/system/files/official-document/diaeed2018d3_en.pdf

https://www.sec.gov/divisions/corpfin/internatl/issues0501.htm

Unit 04 :International Financial Analysis

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the meaning, features and types of a Financial Statements,
- describe the concept of Financial Statement Analysis,
- explain the meaning of International Financial Statement Analysis.
- explain the need and significance of International Financial Statement Analysis.
- understand the challenges in doing Foreign Financial Statement Analysis

Introduction

Financial statements provide a summary of accounts of a business enterprise, the balance sheet reflecting the assets, liabilities, and capital as of a specific date, and an income statement showing the results of operations of a certain period.These are a compilation of financial data arranged and organized in a systematic and summarized manner in accordance with the accounting principles to assess an enterprise's financial position regarding its profitability, operational efficiency, long and short-term solvency, and growth potential.On the basis of whatever information is disclosed in Financial Statements, users of them come to know about the growth, profitability, solvency, and financial strength of an enterprise. These are prime tools in the hands of the management of an enterprise by which it can present its financial position to the interested parties such as shareholders, lenders, and creditors.Financial Statements provide the prime information for the financial analysis of a concern. These act as the prime aid for financial analysis by disclosing all the material information before the users.

4.1 Definition of Financial Statements

AICPA (1936)

Financial statements are prepared to present a periodic review or progress of management and deal with the status of investment in business and results achieved during the period under review.

They reflect a combination of recorded facts, accounting conventions, and personal judgements, and the judgements and conventions applied affect them materially. The Soundness of judgement necessarily depends on competence and integrity of the ones' who make them and on their adherence to generally accepted accounting principles and conventions.

Myer (1969) opined that Financial statements provide a summary of accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as of a certain date and income statement showing the results of operations of a certain period.

4.2 Meaning of Financial Statements Analysis

It is a methodical and systematic analysis and interpretation of data as disclosed in the income statement and the balance sheet of a business to extract necessary and relevant information for the management to determine liquidity, solvency and profitability, activity, and managerial performance of the enterprise.

Features of Financial Statements

- Record transactions into monetary value. Financial Statements are prepared at the end of a given financial year.These reflect the results of the past activities of the enterprise, and accordingly, they are called historical evidence.
- Application of accounting principles, concepts, conventions, and postulates
- Reliable, meaningful and comparable financial data makes it easy to understand the financial performance of a company
- Financial Statements exhibit periodical financial information of an entity
- Prepared at the end of every accounting year
- Financial Statements should incorporate the summary of the financial information of all the activities of the concern.
- It includes the financial information of operating, investing, and financing activities of the concern.
- Disclose all the information as required by the Law of the country.
- Should be presented:
    - in conformity with the applicable legal provisions.
    - in conformity with the relevant accounting standards of the country.
- A number of statements are prepared at the end of every accounting period which is collectively known as financial statements.

4.3 Types of Financial Statements

Income Statement or Profit and Loss Account

- A summary of a company's revenues, expenses, and profits/losses over a given period .
- Shows a company's ability to generate sales, manage expenses, and create profits

Balance Sheet

- A balance sheet is a financial statement that reports a company's assets, liabilities, and shareholder equity

- It provides a snapshot of a company's finances (what it owns and owes) as of the date of publication

Fund Flow Statement

Reveals the reasons for changes or anomalies in a company's financial position between two balance sheets.

Fund flow statements portray the inflow and outflow of funds - or the sources and applications of funds over a particular period.

Cash Flow Statement

Cash flow statement shows inflow and outflow of cash and cash equivalents from various company activities during a specific period under the principal heads, i.e., operating, investing, and financing activities.

Information through the Cash Flow statement is useful in assessing the ability of any enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows.

Taking economic decisions requires an evaluation of the ability of an enterprise to generate cash and cash equivalents, which is provided by the cash flow statement

Statement of Comprehensive Income

It is a more robust document that often is used by large corporations with investments in multiple countries.

Summarizes both standard net income and other comprehensive income (OCI).

The net income is the result obtained by preparing an income statement. Whereas other comprehensive income consists of all unrealized gains and losses on assets that are not reflected in the income statement.

Statement of Changes in Equity

Summarizes the transactions related to the shareholder’s equity over an accounting period.

Movement in retained earnings, other reserves, and changes in share capital such as the issue of new shares and payment of dividends are recorded in this report.

It reconciles opening balance and closing balance of shareholder’s equity.

4.4 Analysis and Interpreting Financial Statements

Ratio Analysis

- A ratio is “the indicated quotient of two mathematical expressions and the relationship between two or more things.”
- Here ratio means financial ratio or accounting ratio, which is a mathematical expression of the relationship between accounting figures

Comparative Financial Statement

- A document used to compare a particular financial statement with prior period statements.
- Previous financials are presented alongside the latest figures in side-by-side columns, enabling investors to identify trends, track a company's progress and compare it with industry rivals.

Common Size Financial Statement

- It displays items as a percentage of a common base figure, total sales revenue, for example.
- This type of financial statement allows for easy analysis between companies or periods for the same company.

Trend Analysis

- Used in technical analysis that attempts to predict future stock price movements based on recently observed trend data.
- It uses historical data, such as price movements and trade volume, to forecast the long-term direction of market sentiment.

4.5 Need and Significance for Foreign Financial Statement Analysis

- Foreign Portfolio Investment
- International Mergers and Acquisitions
- Making credit decisions about foreign customers
- Evaluating the financial health of foreign suppliers
- Benchmarking against global competitors

Benefits of Foreign Portfolio Investment

- Investment Diversity
- International Credit
- Access to Bigger Market
- High Liquidity
- Exchange Rate Benefit
- Promotes development of Equity Market

Risks Associated with Foreign Portfolio Investment (FPI)

- Volatile asset pricing
- Jurisdictional risk

Advantages of Foreign Mergers and Acquisitions

- Increase overall performance efficiency
- Stimulate growth
- Gain competitive advantage
- Strengthen supply chain

Evaluating the Financial Health of Foreign Suppliers

- Supplier's Profitability Ratios
- Supplier's Liquidity Ratios
- Supplier's Activity Ratios
- Supplier to Averages for that Industry

Supplier's Profitability Ratios

- Return on Assets (calculated as Net Income / Total Assets)
- Return on Equity (Net Income / Stockholders' Equity),
- Gross Profit Margin ([Sales – COGS] / Sales),

- Net Profit Margin (Net Income / Sales).

Supplier's Liquidity Ratios

- Current Ratio (Current Assets / CurrentLiabilities),
- Quick Ratio ([Current Assets – Inventory] / Current Liabilities),
- Net Working Capital Ratio ([Total Current Assets – Total Current Liabilities] / Total Assets).

Supplier's Activity Ratios

- Accounts Receivable Turnover
- Accounts Payable Turnover
- Inventory Turnover

Supplier to Averages for that Industry

Benchmarking Against Global Competitors

Comparisons between different companies and industry norms.

Evaluate the performance of a business by focusing on one or more particular indicators.

- The term 'benchmarking' refers to the process of comparing the business practices and performance standards of your company to that of other firms within the same industry. Quality, time, and cost are the most common values that are measured.
- Essentially using the best practices of other businesses in the same industry as a 'benchmark' to improve the practices of your own company.
- Improvements that are made from learning through the results of benchmarking can help a business to run more efficiently and become much more cost-effective.
- Financial benchmarking involves conducting financial analysis and comparing the results to assess a company's competitiveness, efficiency, and productivity.
- There are hundreds of benchmarks in use; understanding some of the most common metrics can help you determine if this performance measurement method is suitable for your business.
- The information gained from such a comparison allows firms to determine how well they perform in comparison with the "best" and, in turn, develop new and better strategies to work towards making improvements or adopting certain best practices. Benchmarking is usually an ongoing process in which companies continuously seek the progress of their practices.

Important Benchmarks to Consider

- When comparing the current state of your company to the current state of other similar companies that you compete with, there are many important data points for you to consider.
    - Operating costs
    - Gross profits
    - Net profits
    - Sales trends and profitability trends
    - Marketing expenses as a percentage of gross revenue

- Cost per employee
- Revenue per employee
- The ratio of revenue to fixed assets

- Once you've identified your competitors, comparing these data points to that of your company allows you to determine how well you are performing against the competition.
- Since competing companies will likely be operating a business very similar to your own, it's valuable to have the means to analyze and learn from how they're running their operations while saving costs to generate higher profits.
- Doing it this way may also reveal constant bottlenecks in your operation and highlight key areas where there is room for improvement. Likewise, identifying these key areas enables you to use them as leverage so you can set yourself further apart and always be one step ahead of the competition.

4.6 Difficulties in Analyzing Foreign Financial Statements

- Reliability and Timelines
- Language and Terminology
- Dependence of Expert services
- Annual report form and content
- Currency
- Accounting Principles and Practices
- Difference in Income Determination
- Disclosure and Presentation differences
- Environmental differences
- Database Accessibility and availability

- Reliability and Timelines

A prerequisite to successful analysis is the availability of reliable information promptly. There are abundant data sources for investment analysis in developed countries such as the United States.

The analyst can recourse to corporate filings with the Securities and Exchange Commission (SEC). Besides, various financial services such as Moody's Investor Services and computerized data banks such as COMPUSTAT, Governmental publications of the US Treasury Department, etc. and indexes of security prices such as Dow-Jones Averages are rich sources of financial information for the analyst.

In fact, recognizing the financial marketplace's increasing demand for transparency and additional data on developed and emerging markets, S & P COMPUSTAT made significant announcements.

- In April 2008, it announced that it would provide extensive fundamental and market data for all companies incorporated in Korea through an agreement with the Korean Listed Companies Association (KLCA).
- S&P Compustat provides financial information on over 28,000 North American, publicly-held companies from the 1950s to the present.
- The availability of information has improved with the requirement of many stock exchanges to make available information online.
- An amendment to the Indian Companies Act provides for the documents in electronic form duly authenticated with digital signatures shall be accepted under the Act.
- Making your business or company transactions quick and easy is vital in the fast-paced world we live in today. The digital signatures option enables the customers to sign and send documents electronically, such as email, avoiding cumbersome and time-consuming processes.
- This shows that you allow fast transactions and that you also have respect for their time. The situation in India is also much better with databases such as Prime Database, etc.,

being available. The problem of data accessibility is further compounded by the delay in the receipt of foreign information.

- The range is vast, from 30 to 60 days for many European countries and the USA and Canada; in India, it generally ranges from 90 to 120 days. As per the Companies Act's provisions, the directors must present annual accounts for the shareholders' consideration.
- The accounts have to be filed with the Registrar of Companies within 30 days of the annual general meeting. This information delay is bound to impair the decision of the investor.

- **Language and Terminology**
- An analyst may discover that the information available may not be intelligible on account of language and terminology barriers
- English is the most acceptable medium, yet companies domiciled in non-English speaking countries publish their accounts in their own national language
- For instance, financial statements are published in countries like Austria, France, Mexico, South Korea, Japan, and China. Spain and a host of other countries are predominantly non-English. Thus, unless the information is in a language comprehensible to the analyst, meaningful insights cannot be obtained

- **Dependence of Expert services**
- Language is, however, not an impossible barrier for the analyst, and there are ways in which it may be overcome. The analyst may, for instance, develop multilingual capabilities. This barrier could, thus, be removed by acquiring familiarity with a few foreign languages that are important for the analyst
- One way to achieve this is by imparting optional instructions to students of accounting and finance at the postgraduation level itself, as is being done in case of students of international business in India and elsewhere
- Many large companies provide translations for the readers. To cite a few examples: In Norway, AKER, one of the country's largest and leading companies, provides an English version of its Norwegian report. Again, SKF Sweden also published English translations of their Swedish reports
- Similarly, the Olivetti group in Italy and Alcatel Lucent in France also translate their statements' Italian and French versions into English. Global Tech Appliances Inc in Hong Kong provides the Chinese version of the annual reports on request
- The Royal Dutch Petroleum Company in the Netherlands supplies investors with English, French and German versions of the original Dutch report. Listing agreements in many countries require listed companies to provide translated versions of the report to shareholders of that country.
- For instance, the Tokyo Stock Exchange requires a foreign company listed on the exchange to provide a Japanese version of the annual report to beneficial shareholders in Japan.
- Infosys in India also prepares its financial statements (in summary form) for its shareholders in Germany, France, and Japan, not only in the respective countries.
- These translations, however, need to be read with caution, for at times they may be little more than a marketing document. The reason being, of at these versions are not the statutory accounts and are prepared for the convenience English language readers for information purposes only.
- The language problem can also be overcome by employing expert translators to do the job. In fact, using professional translators on a one-time basis to translate key account titles and terms would be much more economical than training accountants or financiers.
- The problem could also be tackled by using accounting lexicons to translate foreign language account titles and terms into the desired language.

- The problem is not restricted to language alone; differences in terminology provide ample scope for confusion. Misunderstanding can arise on two counts.
- First, the same word may have different meanings when used in the financial statements of different countries. One such example is the term 'stock' which denotes materials in the financial statements published in some countries.
- India is one such example, whereas the term 'common stock' in a US report would mean ordinary shares, though quite a few companies in the USA also use the term shares. The second count on which misunderstanding may arise is the use of different terms to denote the same meaning, particularly in statements that are translated versions.
- Examples of such terms include debtors/accounts receivables, creditors/accounts payables, turnover/sales revenue, profit and loss account/statement of operations, stock/ inventories, provisions/allowances/reserves for bad debts.
- For instance, though UK companies have switched to the term trade receivable and payables,' financial statements in India continue to use the terms, sundry debtors.
- It will thus be seen that different words are used to describe the same thing not only in different countries but also by different companies in the same country. Even the abbreviations used for the same currency may vary.
- An example is the Swedish Kroner which is abbreviated SEK or Skr. Similarly, TSEK. or Tkr. MSEK or Mkr is usually the abbreviations for thousands of Kroner and millions of Kroner, respectively.
- Translated versions sometimes create confusion because the translation is done on the basis of dictionary equivalents by expert linguists, whereas the technical meaning in accounting may be different. However, these language and terminology problems are trivial and can be overcome if the analyst exercises a little caution and skill.•

- **Annual report form and content**
- Back in 2002, the world seemed to be on the verge of an accounting revolution. An initiative was underway to create a single set of international accounting standards, with the ultimate aim of uniting the U.S. Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS) that European countries were in the process of adopting.
- By 2005, all public companies in the European Union had, in theory, abandoned their local accounting standards in favor of IFRS. Today, at least 110 countries around the world use the system in one form or another.
- But in a broad sense, convergence has stalled, and further substantive changes seem unlikely in the near future. To be sure, progress has been made, but understanding the true value of a firm and comparing company accounts across countries continue to be major challenges.
- Consider the implications of failing to reconcile GAAP and IFRS. The analysis of investment targets, acquisitions, or competitors will, in many cases, continue to require a comparison of financial statements under two distinct accounting regimes: Pfizer versus GlaxoSmithKline, Exxon versus BP, Walmart versus Carrefour—in each case, one company uses GAAP and the other uses IFRS.
- The impact on results is hardly trivial. Let us take the example of the British confectionary company Cadbury. Just before it was acquired by the U.S. firm Kraft in 2009, it reported IFRS-based profits of $690 million.
- Under GAAP, those profits totaled only $594 million—almost 14% lower. Similarly, Cadbury’s GAAP-based return on equity was 9%—a full five percentage points lower than it was under IFRS (14%). Such differences are large enough to change an acquisition decision.
- To further complicate matters, the way that IFRS regulations are applied varies widely from one country to the next. Each has its own system of regulation and compliance, and in many countries (especially in the fastest-growing emerging regions), compliance and enforcement are weak. The quality and independence of the accounting profession are also often patchy.

- **Currency**
  - Accounting currency is the monetary unit used to record financial transactions in a company's accounting records, and it is crucial for the company's bookkeeping or general ledger maintenance.
  - While learning about the meaning of accounting currency, we should also keep in mind that it is not necessarily the same as a functional or transactional currency.
  - For example, a company may be headquartered in the US but operate majorly in Canada, so employees and customers would generally transact in Canadian dollars (CAD), especially in the case of sales. When the company is maintaining its financial records, it should convert the CAD to US dollars (USD) as it is the standard accounting currency.
  - Accounting currency maintenance is essential for large multinational companies that do business in many different countries, as the conversion rates keep changing constantly, and the companies have to decide if they want to use the temporal or historical method or the current-rate method.
  - A company can choose its accounting currency. Still, it cannot change its functional currency, as operations in a foreign country with a different foreign currency may not be feasible. A company can choose from either the temporal or current-rate currency translation method.
  - Temporal or historical method: Assets and liabilities are divided into monetary and non-monetary categories. Monetary assets are highly liquid such as cash, investments, and accounts receivable, while liabilities due to be paid out in the short term, such as accounts payable and salaries payable, are considered monetary liabilities.
  - The exchange-rate values for non-monetary assets and liabilities are converted by the rate based on the time those assets and liabilities were acquired or incurred.
  - Current-rate method: Assets and liabilities on the balance sheet are converted at the exchange rate as of the balance sheet date. However, this can create a higher translation risk, as the current exchange rate may change drastically before the end of the accounting period.
  - Let's consider an example related to it. A Fast Moving Consumer Goods Company has decided to present its financial statements in USD, but as its operations are heavily concentrated in the UK, its functional currency is the British pound sterling (GBP). XYZ also has various subsidiaries across the globe that report in euros (EUR), Australian dollars (AUD), and Japanese yen (JPY).
  - When XYZ's subsidiaries and operations are preparing a consolidated report for its parent organisation, they have to do it in the accounting currency, which in this case is USD.
  - Now that we have accounting currency explained, let's understand the difference between accounting currency and reporting currency. While accounting currency is commonly referred to as reporting currency, there is a significant difference between them. Accounting currency is what the legal entity or the headquarters chooses to use for calculating amounts or bookkeeping using a general ledger. Therefore, it must pick a unique currency per the legal entity. Reporting currency is used for operational reporting to the government bodies. So, for example, if XYZ chooses to have GBP as an accounting currency but is primarily based in the US, it must use USD to report to government bodies.

- **Accounting Principles and Practices**
  - The issues discussed so far were insignificant, and though they caused inconvenience to the analyst, they could be resolved with some effort. However, the second set of issues is more complicated and significantly impacts the analysis if dealt with incorrectly. These differences relate to the accounting practices prevalent in different countries.

- As mentioned earlier, the past one and a half decades have witnessed considerable progress in the direction of convergence of accounting standards. However, diversities still prevail on account of differences in the legal environment in the levels of economic development of countries and the state of development of the accounting profession, etc.
- These differences may be for the sake of convenience. be classified into:

Conceptual Differences

- The differences in this category relate to certain basic accounting concepts, such as stable money measurement or preparing the parent's and its subsidiaries' statements as they constitute a single economic entity, etc.
- The important issues in context of conceptual differences are:
- Consolidation of financial statements
  - Consolidation of financial statements: The concept of consolidated financial statements is based on the assumption that a group of enterprises can be treated as a single accounting entity regardless of any legal distinctions that may exist among the separate corporate entities.
  - The consolidated financial statements thus provide an overall financial view of the group of companies, saving the users the botheration of putting together reports of the individual subsidiaries.
  - In the context of consolidation, a group comprises the parent and its subsidiaries. The absence of consolidation resulted in a lot of off-balance sheet financing. Hence, with the increase in pressure from foreign investors, developing countries, particularly, were required to incorporate provisions in the regulatory setup to enforce the consolidation of financial statements.

Treatment of investment in associates

- An associate is an enterprise in which the investor has significant influence but which is neither a subsidiary nor a joint venture of the investor. IAS 28 treats investments by venture capital organizations, mutual funds, and similar entities separately.
- For other situations, it prescribes the use of the equity method. According to the equity method, the investment should initially be recorded at cost. Subsequently, it is adjusted for the investor's share in a change in the investee's post-acquisition profit or loss and net assets.
- Such investments should be dealt with in accordance with the provisions of the relevant standard. Differences in the accounting of treatment provisions in different standards generally relate to considering the effect of potential voting rights when assessing significant influence.
- When the significant influence over the associate is lost, investment should be recorded to its fair value at that date, with the gain or loss being recognized to the remaining holding. Where consolidated statements are not prepared, equity accounting is to be used.
- In separate financial statements are not prepared, equity accounting is accounted for at cost or as an investment per the provisions of IAS 39 dealing with statements of the parent. The investment has to be a presentation of financial instruments.

Revaluation of fixed assets

- There are certain entities in the world that follows FRS15, while some follow IAS16 for revaluating the fixed assets. There are significant differences between IAS 16, Property, Plant, and Equipment (the international standard) and FRS 15, Tangible Fixed Assets (the UK standard) in relation to revaluation and derecognition compared to initial measurement and depreciation.

IFRS15 Vs IAS16

- o The basis are:
- ▪ Revaluation OF PPE
- ▪ Derecogntion of PPE – IAS16 position
- ▪ Disposal of PPE
- o Revaluation gains – IAS 16
- ▪ IAS 16 allows entities the choice of two valuation models for PPE – the cost model or the revaluation model. Each model must be applied consistently to all PPE of the same class.
- ▪ A class of assets is a grouping of assets that have a similar nature or function within the business.
- ▪ For example, properties would typically be one class of assets, and plant and equipment another. Additionally, if the revaluation model is chosen, the revaluations need to be kept up to date, although IAS 16 is not specific as to how often assets need to be revalued.
- ▪ When the revaluation model is used, assets are carried at their fair value, defined as 'the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.'
- ▪ These are recognized in equity unless they reverse revaluation losses on the same asset that was previously recognized in the income statement. In these circumstances, the revaluation gain is recognized in the income statement. Revaluation changes the depreciable amount of an asset, so subsequent depreciation charges are affected.
- ▪ These are recognized in equity unless they reverse revaluation losses on the same asset that were previously recognized in the income statement. In these circumstances, the revaluation gain is recognized in the income statement. Revaluation changes the depreciable amount of an asset so subsequent depreciation charges are affected.
- ▪ Revaluation losses are recognized in the income statement. The only exception to this rule is where a revaluation surplus exists relating to a previous revaluation of that asset. To that extent, a revaluation loss can be recognized in equity.

- Revaluation of PPE – FRS15 position
- FRS 15 is more specific than IAS 16 regarding the frequency of valuations. For example, FRS 15 states that, as a minimum, assets should be revalued every five years. Under FRS 15, the amount to which a fixed asset is revalued is different than under IAS 16.
- As far as properties are concerned (these probably being the class of fixed asset most likely to be carried at valuation), the basic valuation principle is value for existing use – not reflecting any development potential. Notional, directly attributable acquisition costs should also be included where material.
- However, specialised properties may need to be valued on the basis of depreciated replacement cost since there may be no data on which to base an 'existing use' valuation. If

properties are surplus to the entity's requirements, they should be valued at open market value net of expected directly attributable selling costs.

- Revaluation losses that are caused by a clear consumption of economic benefits, for example, physical damage to an asset, should be recognised in the profit and loss account. Such losses are recognised as an operating cost similar to depreciation.
- Other revaluation losses, for example, the effect of a general fall in market values on a portfolio of properties, should be partly recognised in the statement of total recognised gains and losses. However, suppose the loss is such that the carrying amount of the asset falls below depreciated historical cost. In that case, any further losses need to be recognised in the profit and loss account.
- Derecognition of PPE – the IAS 16 position
  - PPE should be derecognised (removed from PPE) either on disposal or when no future economic benefits are expected from the asset (in other words, it is effectively scrapped).
  - A gain or loss on disposal is recognised as the difference between the disposal proceeds and the asset's carrying value (using the cost or revaluation model) at the date of disposal.
  - This net gain is included in the income statement – the sales proceeds should not be recognised as revenue.
    Where assets are measured using the revaluation model, any remaining balance in the revaluation reserve relating to the asset disposed of is transferred directly to retained earnings. No recycling of this balance into the income statement is permitted.

- Disposal of Assets – IFRS 5 position
  - IFRS 5, Non-current Assets Held for Sale and Discontinued Operations is another standard that deals with the disposal of non-current assets and discontinued operations.
  - An item of PPE becomes subject to the provisions of IFRS 5 (rather than IAS 16) if it is classified as held for sale. This classification can either be made for a single asset (where the planned disposal of an individual and fairly substantial asset takes place) or for a group of assets (where the disposal of a business component takes place). This article considers the implications of disposing of a single asset.
  - IFRS 5 is only applied if the held for sale criteria are satisfied, and an asset is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continued use.
  - For this to be the case, the asset must be available for immediate sale in its present condition, and its sale must be highly probable. Therefore, an appropriate level of management must be committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan must have been initiated.
  - The asset needs to be actively marketed at a reasonable price, and a successful sale should normally be expected within one year of the date of classification.
  - The types of assets that would typically satisfy the above criteria would be property and very substantial items of plant and equipment. The normal disposal or scrapping of plant and equipment towards the end of its useful life would be subject to the provisions of IAS 16.
  - When an asset is classified as held for sale, IFRS 5 requires that it be moved from its existing balance sheet presentation (non-current assets) to a new category of the balance sheet – 'non-current assets held for sale'.

- No further depreciation is charged as its carrying value will be recovered principally through sale rather than continuing use.
- The existing carrying value of the asset is compared with its 'fair value less costs to sell (effectively the selling price less selling costs).
- If the sum of the undiscounted future cash flows is less than the carrying value of the asset, then the asset is impaired and the company must measure the impairment loss. When the asset is sold, any difference between the new carrying value and the net selling price is shown as a profit or loss on sale.
- The FRS 15 position is effectively identical to that of IAS 16 in as far as the derecognition of PPE is covered by IAS 16. However, there is no UK standard equivalent to IFRS 5, although the UK Accounting Standards Board has issued an exposure draft that is very similar to IFRS 5.

- Accounting for price level changes.
- Debates on inflation accounting were in full swing during the 1970s as inflation rates were high. Since the 1990s, however, inflation rates have declined in most countries of the world. Even in countries such as Chile, it remained stable at around 2-3 percent during 2003-04.
- Consequently, debates on inflation accounting have subsided. The issue, however, cannot be treated as dead. Debates on such issues raise their heads as soon as there are significant and continuous signs of increases in the price level. The year 2007-08 has already witnessed some upward movement in prices.
- Thus, though the enthusiasm for accounting for price level changes has dampened considerably in recent years as a result of the slowing down of the rate of inflation in important countries,
- The analyst should not overlook the fact that even when inflation rates have slowed down, accounting for changing prices is useful since:
- 1. The cumulative effect of a low rate of inflation over time can be significant
- 2. The distorting effect of price inflation can persist for many years
- 3. Specific price changes may be significant even though changes in the general price level may not be so.
- When examining the financial statements, the analyst should adopt a cautious approach. The use of traditional foreign currency translation methods does not explicitly provide a cure for the malady.
- Hence, to provide meaningful information in consolidated financial statements, the treatment of overseas inflation will entail stretching the consolidation procedure to incorporate adjustments for changing prices.
- The analyst must therefore be conversant with the approaches that companies may adopt for this purpose, as different approaches would have a different impact on reported profits. Some countries like India do not have an accounting standard dealing with hyper-inflationary situations.

- Difference in Accounting

- Accounting differences hinder cross-country comparisons. Differences in business environments might make ratio comparisons meaningless even if accounting differences are eliminated
- Differences in disclosure and presentation
- Various aspects have a significant impact on reported income of a concern are:
- Stock valuation
- Depreciation Policy
- Intangible assets
- Foreign currency translation
- Segment reporting
- Disclosure and Presentation differences
- Important issues to be considered are:
- Changes in accounting policy
- Accounting for leases and rental commitments
- Provision for Contingent Liabilities

- Environmental differences
- Political
- Cultural
- And Social environment is important to predict future financial performance of company
- Database Accessibility and availability
- A database is an organized collection of structured information, or data, typically stored electronically in a computer system. A database is usually controlled by a database management system (DBMS).
- More diff for foreign companies:
- International investment in equities has become more prevalent, and several companies have developed databases that provide foreign companies' financial info (Standard & Poor's, Worldscope).
- Most data sources provide additional info, such as financial ratios and stock prices.
- Limitations using commercial databases:
- Potential for errors when entering info into the database.
- Format BS and IS differ across countries.
- Common format might lose information.
- None of the commercial databases provides a complete set of notes (provide qualitative/quantitative information).
- Financial statements are not made available on a timely basis

4.7 Business Analysis Framework

The conceptual blueprint describes all the vital requirements for getting the business done. It is based on knowledge utilization, various techniques which comprise the process, and also the critical analysis.

All of this is essential for the analyst to ensure that a step-by-step approach is implemented to align your business practices with the company. The business analytics framework is a natural structure and / or concept that involves using a range of knowledge, practical techniques, and established concepts to quickly discover, critically analyze, and accurately maintain the company's needs.

The field of business analysis is very diverse. The number of business analytics process requirements and customer expectations is continuously increasing, which is due to the changing business landscapes that are brought about by technical advances.

The framework provides a break from rumors as a trusted source that can help you run your business through troubled waters.

In other words, most organizations use frameworks for their main purpose: as a reference model that they can use to understand your processes and build a model or structure that ensures that the work is done efficiently and is constantly monitored.

Steps in Business Analytics Framework

- Examine
- Outlook
- Need analysis
- Evaluate options
- Requirement definition

Techniques Used in Framework

- SWOT Analysis
- MOST Analysis
- Business Process Modelling
- **Non-Functional Requirement Analysis**
- Brainstorming
- Requirement Analysis
- Shadowing
- Prototyping
- CATOWE
- Use Stories
- PESTLE Analysis

Summary

The business environment is constantly changing. There are increasing uncertainties and unforeseen challenges arising from the complexity of the hyper-connected global economy. The pace of development is a compelling argument in favor of constant review and revision of your business strategies. Convergence of the digital and social spheres, and there cannot be an isolated strategy to deal with both. The basic rules are "innovate or perish." Survival is for those who stay at the forefront of innovation and constantly create new products. This has made the role of a business analyst very challenging and intuitive. You need to have a thorough understanding of business value propositions, cultivate a spirit of innovation, and constantly focus on product value. From the discussion made so far one can actually make the difference in the success or failure of the organization as it faces the challenges of the 21st century.The main goal of the business analysis framework is to ensure that all business processes are efficient and run smoothly and to reflect all the techniques that business analysts can use to collect and realize requirements.A good business analyst always adheres to the fundamentals of the basic Financial analysis framework. His role is basically to make the client and the customer happy by ensuring their requirements have been met. The whole process works fine and is the prime responsibility of the analyst. There are some of the challenges that were encountered while analyzing the financial statements. However, it is easy to overcome these bottlenecks if they are tackled tactfully.

Keywords

- Business Analysis Framework:A business analysis framework is a conceptual plan that describes all of the key requirements for running a business. It is based on the use of knowledge, the various techniques that make up the process, and also critical analysis.
- MOST Analysis: MOST analysis simply helps companies set defined goals for the entire team and organization by deciding, Mission, Objectives, Strategy, Tactics
- Brainstorming: Generating more ideas, doing root cause analysis, and even suggesting solutions to various problems is the fundamental technology used for other business analysis techniques such as SWOT analysis, MOST analysis, etc.
- Shadowing: The technology focuses on the analysis of the real business environment and thus on the observation of the reactions and problems of the end user. Through close observation, a BA can record current issues and suggest improvements. Of two types: passive and active In the first case, the BA observes passively without disturbing the individual; in the second case, the BA has the opportunity to interact with the individual at any time.
- Prototyping: This is an essential technique for gathering requirements. It is helpful for the business analyst to get the most relevant feedback. Low-fidelity prototypes are more useful for owners to understand the typical use case and provide feedback. Also, as they go through the design, business owners can understand more and therefore provide a more detailed fee.
- CATWOE: It provides a general business analysis thought process to understand the business goal. It lists the vulnerabilities and how the proposed solution will affect both the company and those associated with it.
- PESTLE Analysis: Political, Economic, Social, Technical, Law, Environmental factors have profound and apparent impacts on businesses and must be factored in during any strategic planning.

Self Assessment

1. A company's quick (or acid test) ratio is higher than the industry average, implying.

A. The company has a higher P/E ratio than other companies in the industry.
B. In the short run, the firm is more likely to escape insolvency than other enterprises in the industry.
C. The company may be less profitable than competitors in the industry.
D. B and C

2. A company's quick (or acid test) ratio is lower than the industry average, implying.

A. The company has a lower P/E ratio than other companies in the industry.
B. In the short run, the firm is less likely to escape insolvency than other enterprises in the industry.
C. The company may be more profitable than competitors in the industry.
D. B and C

3. Examples of liquidity ratios are:

A. fixed asset turnover

B. current ratio

C. acid test or quick ratio

D. B and C

4. ....is a snapshot of the firm's financial situation at a specific point in time.

A. The income statement

B. the balance sheet.

C. The cash flow statement

D. All of the above supply

5. Which of the following is not an element of PESTLE Analysis

A. Political

B. Social

C. Technical

D. Leverage

6. ……..lists the vulnerabilities and how the proposed solution will affect both the company and those associated with it.

A. CATWOE

B. Prototyping

C. Use Stories

D. Shadowing

7. …….The technology focuses on the analysis of the real business environment and thus on the observation of the reactions and problems of the end user. Through close observation, a BA can record current issues and suggest improvements.

A. CATWOE

B. Prototyping

C. Use Stories

D. Shadowing

8. This is an essential technique for gathering requirements. It is helpful for the business analyst to get the most relevant feedback.

A. CATWOE

B. Prototyping

C. Use Stories

D. Shadowing

9. The requirements are best gathered from the users to create the project. Since it is the user's perspective as the central idea, it is very effective.

A. CATWOE

B. Prototyping

C. Use Stories

D. Shadowing

10. …….Generating more ideas, doing root cause analysis

A. Brainstorming
B. Prototyping
C. Use Stories
D. Shadowing

11. Which of the following is not an element of MOST
A. Mission
B. Objectives
C. Strategy
D. Technology

12. These define the methods by which strategies are developed
A. Mission
B. Objectives
C. Strategy
D. Tactics

13. Which of the following is not an element of SWOT
A. Strengths
B. Weaknesses
C. Opportunities
D. Trades

14. They relate to the potential scope of business growth
A. Strengths
B. Weaknesses
C. Opportunities
D. Trades

15. These factors intimidate the business's very survival
A. Strengths
B. Weaknesses
C. Opportunities
D. Threats

Answers for Self Assessment

l.	D	2.	D	3.	D	4.	B	5.	D
6.	A	7.	D	8.	B	9.	C	10.	A
11.	D	12.	D	13.	D	14.	C	15.	D

Review Questions

1) Explain the meaning and dimensions of international financial analysis.
2) Explain the need and significance of international financial analysis.

3) What are the problems in international financial analysis?
4) What are the tools of international financial statement analysis?
5) Describe the business analysis framework.

Further Readings

A text book on International Accounting and Reporting Issues: 2018 Review by United Nations Conference on Trade and Development (UNCTAD) · 2019

A text book on Dual Reporting for Equity and Other Comprehensive Income by Francesco Bellandi

Web Links

- https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/foreign-portfolio-investment-fpi/
- https://www.studeersnel.nl/nl/document/rijksuniversiteit-groningen/international-financial-management/analysis-of-foreign-financial-statement/8304233
- https://www.nirmalbang.com/knowledge-center/foreign-portfolio-investment.html

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Unit 05: International Harmonization of Financial Reporting

CONTENTS

Objectives

After studying this unit, you will be able to:

- understand the meaning and significance of Harmonization.
- understand the challenges of Harmonization
- describe the convergence of Accounting Standards
- know the conceptual framework of IFRS.
- know the foundation of IFRS.

Introduction

Harmonization of accounting practices aims to bring down the disparities in financial reporting systems practiced by different countries owing to their own socio-economic, political, cultural, and legal systems. The purpose of harmonization is to increase the comparability of accounting practices as followed by different nations across the globe. Standardization, often used as synonymous with harmonization, too aims at reducing disparities, too aims at reducing disparities in accounting practices, but not without a set of rigid rules and policy guidelines as compared to harmonization. It is the process of harmonization which is preferred to standardization, as harmonization still allows nations to enjoy certain degrees of freedom while preparing financial reports than under the standardization. Nevertheless, it is mostly through standardization that harmonization of accounting practices is achieved.

5.1 Meaning of Harmonization

Harmonization is the act of making an activity, situation, or process consistent and compatible with other similar works. Harmonization of Accounting Standards is the process of minimizing the differences in accounting standards worldwide. This is to make the financial reporting uniform and comparable. The basic objective of this harmonizing exercise is to improve the comparability and compatibility in preparing and presenting the accounting reports, records, and statements. In the present era of globalization, it has become essential for capital markets to rely upon common accounting reports. Countries can achieve international harmonization of accounting standards only with mutual cooperation and understanding. They must follow similar recording and reporting procedures and rules when preparing financial reports. Harmonization of accounting standards results in building international investor confidence and knowledge. Investors and lenders can easily interpret and compare the financial statements of companies from any part of the globe. They can correctly recognize, evaluate and identify the companies with strong financials that meet their investment requirements. This helps to boost cross-border investments. Also, it helps to make a fair judgment of the companies to invest in. Good investment decisions are the key to creating a competitive edge and increasing the return on investments.

Definition of Harmonization

Christopher and Robert, in their book "Comparative International Accounting," have defined the term Harmonization as a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation, while standardization appears to imply the imposition of a more rigid and narrow set of rules."

Need of Harmonization

The increased globalization of capital markets has resulted in a need for international accounting standards. In an increasingly globalized world, it is clear that the financial statements of companies operating under different accounting management systems are not easily comparable.

This has led to the need and development of the International Accounting Standards Board (IASB), whose stated objective is developing a single set of high-quality, understandable, enforceable, and globally acceptable International Financial Reporting Standards.

The harmonization of accounting standards is needed due to the globalization of businesses and services and an increase in cross-border investments and borrowings.

The reasons can be summarized as:

1. Global Flow of Capital
2. Emergence of MNC's
3. Internationalization of Accounting Profession
4. Administrative Requirements
5. Diversities in measurement of Business Income

1. Global Flow of Capital:

Harmonization of accounting practices is necessary to get an enhanced flow of international capital. It is a well-known fact that from ancient times to the recent euphoria of globalization, business never remained confined to national boundaries.

As such, the flow of capital investments across nations is both a fact and a necessity. The flow, however, gets checked owing to international diversity in accounting practices.

According to the International Organization of Securities Commissions (IOSCO), "the primary impediment to an international offering of securities is that different countries have different accounting standards."

Therefore, harmonization of accounting practices is needed to help international investors get comparable financial information. The greatest benefit that would flow from harmonization would be the comparability of international financial information.

Such comparability would eliminate the current misunderstanding about the reliability of foreign financial statements and remove one of the most important impediments to the flow of international investment, as observed by Turner.

As harmonization would result in more uniform financial reporting across nations, global investors will find it easy to understand the financial data and decide their investment destinations.

2. **Emergence of MNC's:**

   Harmonization of accounting practices greatly reduces the efforts, energy, and money that MNCs otherwise require to put in for presenting financial reports as per country-specific requirements.

   In other words, different countries follow different sets of accounting rules for the presentation of financial reports, and as such, MNCs operating in different countries will have to prepare multiple sets of financial reports to meet the legal requirements of each individual country in which they operate, thus incurring additional expenses.

   Through harmonization of accounting practices, however, these expenses can be reduced as only one set of reports may be just enough to meet the requirements of every country where the MNCs have a presence.

3. **Internationalization of Accounting Profession:**

   Harmonization of accounting practices will help in internationalizing the accounting profession. As harmonization aims at reducing the disparities in accounting practices across nations, accounting professionals operating in one will find it easy to operate in another nation as well.

4. **Administrative Requirements:**

   Different countries have different regulatory and administrative requirements as regards the financial reporting of MNCs.

   For instance, in the US, financial firms are required to furnish financial information in line with the domestic firms and in accordance with the US GAAP.

   Consequently, non-US firms will have to translate and reconcile their financial reports as per the US accounting principles. But for the harmonization of accounting practices, not only would such translations be avoided, but also government and regulatory authorities would be in a better position to understand the financial reports of MNCs and control their operations.

5. **Diversities in measurement of Business Income:**

   Diversities exist in the measurement of business income due to the differences in accounting practices across nations. For example, the same set as per Indian GAAP will be different from that calculated under the US GAAP. By virtue of the harmonization of accounting practices, this profit difference is likely to be substantially reduced.

5.2 Summarizing the Need of Harmonization

- It ensures high-quality financial reporting.
- It ensures reliable financial reporting and disclosures.
- Summarizing the Need of Harmonization

- Harmonization adds to the global credibility of a corporate unit.
- Harmonization makes comparing the corporate unit against the domestic and international peers easier..
- Harmonization provides a level of playing ground where no country is advantaged or disadvantaged by its GAAP.
- Sometimes, Harmonization can prove to be crucial to the economic development of a country.

5.3 Barriers to Harmonization

1. Spirit of Nationalism
2. Different Legal Environments
3. Varying Objectives of Financial Reporting
4. Experience within the respective Agency
5. Collaboration among Agencies
6. Insufficient resources
7. Lack of Strong Professional Accounting Institutes
8. Economic Gap between Developed and Developing Nations
9. Competition among international Standard Setters
10. Political changes
11. Technology

1. Spirit of Nationalism

Each country possesses its regulatory framework and sometimes it is not updated according to the international guidelines because global harmonization is not contemplated by the political agenda of Presidents, Congresses, Senators, and Prime Ministers. This causes the stalling of transformation, innovation, and the capacity to improve public health.

- Spirit of nationalism among accounting professionals in different countries sometimes creates hurdles in accepting compromises which they have to make in changing their accounting practices.
- National pride prevents them from accepting willingly the idea that their accounting principles are inferior to those of another country, Even though the accountant may be a strong proponent of harmonization.
- Frequently, the concept of national identity may be an obstacle to global harmonization as the acceptance of directives different from the internal initiative of the country is often thought of as an infringement or violation of nationalist thinking.
- This has been caused by the lack of bilateral agreements that would allow a mutual acknowledgment.

2. Different Legal Environments

Legal or statutory environment plays a dominant role in the development of accounting thought in every country. Legal systems differ from one country to the other. Since the legal system in a country exercises a strong influence over the accounting and reporting practices, it is clear that unless and until uniformity in laws is possible, it will be difficult to achieve the goal of harmonization of divergent accounting practices. Harmonization of legal systems is required before harmonization of accounting practices there can be a civil code, common law system, and continental system. For example, countries having continental systems are fussy about the enforcement of rules. They do not leave room for an accountant's role. More rigidity prevails there.

3. Varying Objectives of Financial Reporting

The purposes of financial reporting differ from country to country. That can be a possible cause of variation in reporting practices also. Financial reporting in every country is done by keeping in mind the targeted audiences. For example, in North America, the target audiences are the investors and creditors government agencies. whereas, in European countries like France and Germany, accounting is performed for revenue and

4. Experience Within the Respective Agency

Several agencies do not have experts or specialists in every subject. Thus, the introduction of new systems or technologies is frequently a time-consuming process, particularly in Latin American countries.

5. Collaboration Among Agencies

Despite the collaborative work among Regulatory Agencies aimed towards harmonization through different initiatives, they are frequently disrupted as a connection between them is not attained. Therefore, there is no collaboration excepting such an initiative.

6. Insufficient Resources

Several regulatory agencies face resource constraints of different natures such as human, financial, and infrastructure. This lack of resources within institutions causes activity saturation resulting in reduced operative capacity for essential processes. Thus, other activities or projects different from daily activities are left aside.

7. Lack of Strong Professional Accounting Institutes

IASC at the global level is playing a dominant role in the development of IAS's. This committee operates through national professional institutes for example ICAI, and ICWAI are the members of IASC. In countries, where professional institutes are not strong enough to get the standards implemented in their respective countries it will be a difficult task to bring harmonization in divergent accounting practices.

8. Economic Gap Between Developed and Developing Nations

In countries, where professional institutes are not strong enough to get the standards implemented in their respective countries it will be a difficult task to bring harmonization in divergent accounting practices.There is a wide economic gap between developed and developing nations. This gap is a hurdle in bringing out harmonization in divergent accounting practices. It will be better to understand the interaction between the economic and accounting system. Accountants of one nation should maintain a strong link with accountants from other countries to understand practices prevailing in different countries. In reconciling existing diversity in accounting practices, cooperation among accountants, politicians, economists, and educationists is necessary.

9. Competition Among International Standard Setters

Unwanted competition among International institutes which are engaged in developing accounting standards is also a big hurdle in bringing out harmonization. For instance ISAB, OECD and IFAC are trying to develop and review their efforts undertaken by different countries to reduce diversities in accounting practices in their own ways. Increased harmonization can be achieved if collective efforts are undertaken by international standard setters.

10. Political Changes

A change of Federal Government brings about modifications within Regulatory Agencies, most frequently the Heads of such agencies. In most Latin American countries, directive positions within the National Regulatory Agencies have become political positions instead of being of technical-scientific nature. These changes impinge on the actions taken by the former Head as new actions are proposed. This causes the delay and sometimes the termination of any global harmonization activities previously planned.

11. Technology

Due to the aforementioned lack of resources, the implementation of new technologies is deficient within the Agencies. This generates a low availability of information for the interested parties. In turn, this also affects the prompt advancement toward regulatory, technological, and technical harmonization for some agencies.

12. Socioeconomic Aspects

Other aspects that should also be considered regarding harmonization are the costs and fees established by each Agency to evaluate procedures and services. In many cases, this prompts the evaluation of unnecessary procedures causing an additional administrative load that prevents health professionals from developing and implementing optimal evaluation strategies aligned with international standards.

5.4 Meaning of Convergence

The convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. Convergence in some form has been taking place for several decades,and efforts today include projects that aim to reduce the differences between accounting standards. Convergence is driven by several factors, including the belief that having a single set of accounting requirements would increase the comparability of different entities' accounting numbers, which will contribute to the flow of international investment and benefit a variety of stakeholders. Criticisms of convergence include its cost and pace, and the idea that the link between convergence and comparability may not be strong.

Motivations for Convergence

Motivations for convergence include the belief that it will result in increased comparability between financial statements, which will benefit a variety of stakeholders. A 2008 report by PricewaterhouseCoopers (PwC) stated that convergence of accounting standards would contribute to the flow of international investment and benefit "all capital markets stakeholders" because it

- renders international investments more comparable to investors;
- reduces the cost of complying with accounting requirements for global businesses;
- potentially establishes a more transparent accounting system with greater accountability;
- reduces "operational challenges" for accounting firms; and
- gives standard-setters the opportunity to "improve the reporting model".

For example, the FASB believes that "investors, companies, auditors, and other participants in the U.S. financial reporting system" will benefit from converged standards because it will result in increased comparability between the financial statements of different firms.

Additionally, a survey conducted by the International Federation of Accountants found that 89% of accounting profession leaders who responded expressed that convergence was either very important or important for economic growth for their respective countries.

5.5 Accounting Standards

Accounting standards are 'policy documents' issued by professional accountancy bodies at national and international levels, in relation to different aspects of measurement, treatment, disclosure, and presentation of accounting information. The basic purpose behind the issuance of accounting standards from time to time is to minimize the effects on financial statements of the diversities in accounting practices that exist between nations due to their own sock), economic, political, legal, cultural, technological, and environmental setup. Thus by providing standardized accounting policies, accounting standards help in achieving international harmony in the preparation and presentation of accounting information for use by various stakeholders. At the international level, 41 accounting standards called lAS (Exhibit 5.1) and 8 International Financial Reporting Standards popularly called IFRS (Exhibit 5.2) have been issued till date. The remaining 7 standards have been either merged with these 34 or done away with as per the changing environment. Similarly, at the national level, i.e. in India, 32 accounting standards have been issued till date (Exhibit 5.3). It was in 1904 that the idea of setting up international accounting standards emerged in the first International Congress of Accountants held in St. Louis.

5.6 International Accounting Standards (IAS)

In the tenth International Congress, however, leading accounting bodies of ten nations, namely, Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, United Kingdom, Ireland and the USA, agreed to form the International Accounting Standards Committee (IASC) in the year 1973. The IASC, before being restructured to be called as International Accounting Standards Board (IASB) with effect from 2001, had issued forty-one accounting standards (1AS). The IASB, while deciding to retain all the pronouncements of accounting policies made by IASC as International Accounting Standards, also decided to call its own pronouncements of Policies as International Financial Reporting Standards (1FRS). The IASB thus has so far issued six IFRS. Lists of the lAS and the IFRS as practiced today are given in Exhibit 5.1 and 5.2, respectively. The institute of Chartered Accountants of India (ICAO has issued 29 accounting standards as of now. With the withdrawal of AS 8 (on R&D) consequent upon the issuance of AS 26 (on intangible assets), the effective number of AS remains to be 28. These accounting standards aim at bringing the financial reporting system of India at convergence with the international reporting system. Section 211(3A) of the Indian Companies (Amendment) Act, 1999 has made it mandatory for firms to comply with accounting standards for reporting their financial results. Exhibit 5.3 consists of a list of Indian Accounting Standards in practice.

5.7 Convergence of Indian Accounting Standard (AS) with International Accounting Standards (IAS)

In order to achieve harmonization of accounting practices, the convergence of national accounting standards with that international accounting standards is essential.As started earlier, the Indian Accounting Standards operate in convergence with the international accounting standards so that the Indian financial reporting system is at par with the international practice.

5.8 Meaning of IFRS

IFRS or International Financial Reporting Standards refers to a globally-accepted set of accounting and financial reporting guidelines for preparing and presenting financial statements. It ensures uniformity in accounting practice that makes financial records comparable across different reporting entities worldwide. Over the years, it has emerged as the new world standard in accounting.

Objectives of IFRS

- Create a common Law
- Aid analysis
- Assist in preparation of reliable financial records

- Ensure comparability, transparency, and flexibility in reporting

Create a common Law

One of its key objectives is to ensure that common law is introduced and adopted by as many jurisdictions and countries as possible to bring everyone on the same page. It ensures that everyone follows the same guidelines and adopts a universal way of reporting business activities.

Aid Analysis

It helps stakeholders in analyzing a company's performance and interpreting its financial position. For example, corporations and governments use these standards to make credible financial statements. It aids in categorizing and reporting financial data with accuracy and consistency. Such financial records promote better comprehension and help decision-making.

Assist in Preparation of Reliable Financial Records

By following International Financial Reporting Standards, the data presented in the books of accounts are likely to be accurate, reliable, uniform, and appropriate within the bounds of its rules. The high quality of financial records assists investors in making informed economic decisions.

Ensure Comparability, Transparency, and Flexibility In Reporting

The consistency in reporting accounting practices enables easy comparison of the financial records of compliant companies across nations. Such comparisons allow investors to identify risks and opportunities before investing. As a result, it promotes foreign trade and investment. Also, it requires full disclosure of all relevant information to its stakeholders. However, being principle-based, the rules are not very rigid and allow companies to adapt to them in their own way.

Uses of IFRS

- Financial Tool
- Principles and Guide
- Promotes Decision Making
- Improves Economy

Importance of IFRS

- Transparency
- Uniformity and Comprehensive
- Security and Flow
- Accountability

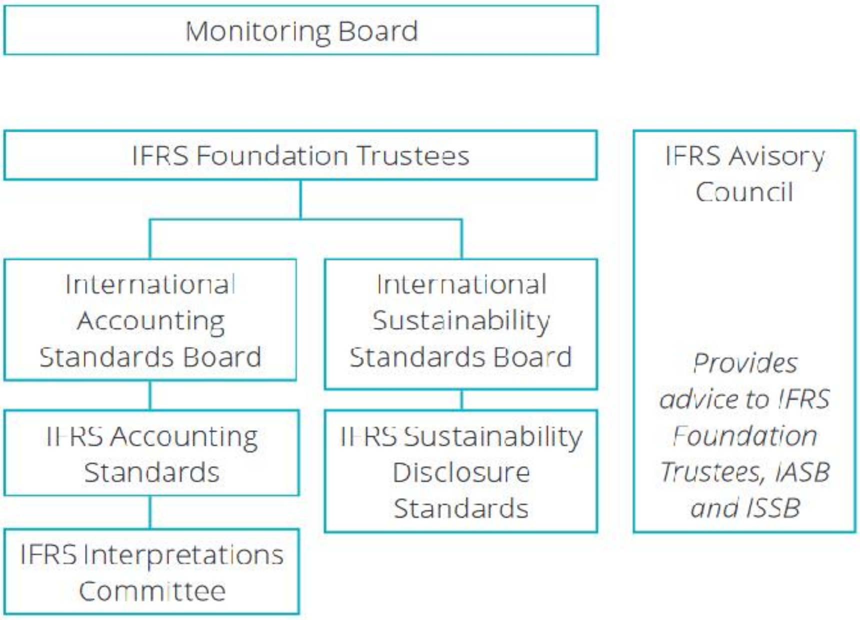
History of IFRS

- U.S. Securities and Exchange Commission[SEC] while evaluating whether and how to incorporate IFRS into the financial reportingsystem for U.S issued a statement in support of convergence and global accounting standards in February 2010. It stated that the Commission continues to believe in the notion that a single set of high-quality globally accepted accounting standards will benefit. U.S. investors and that this goal is consistent with our mission of…….. protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. As a step toward this goal, it shall continue to encourage the convergence of U.S. GAAP [generally accepted accounting principles] and IFRS and expect that the differences will become fewer and narrower, over time, as a result of the convergence project."The SEC then sponsored a series of roundtables in the summer of 2011 to help determine whether incorporating IFRS into the U.S. financial reporting system was in the best interest of U.S. investors and markets. At that time, there was limited discussion about the possible methods of implementing any incorporation, i.e., through the wholesale adoption of IFRS as issued by the IASB, or by regional or nation or endorsement or some combination. The discussion centered mostly on matters regarding how investors use financial statements, investor education, and who should interpret the principles-based standards. There was, however, considerable discussion regarding the role that various stakeholders, such as regulators and public accounting firms, play in interpreting principles-based standards. And rather than leaving the interpretation of the standards to these stakeholders, perhaps the IASB should fund and support a more robust interpretation effort. But the momentum of the issue slowed following the release of a 2012 SEC Final Staff Report (Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers) that questioned the funding of the IASB and the timeliness of responses to widespread accounting issues by the IFRS Interpretations Committee. The report also said adoption of IFRS would be costly for U.S. public companies.

- The SEC emphasized in the report, however, that its publication did not imply that the SEC had made any policy decision as to whether IFRS should be incorporated into the financial reporting system for
- U.S. issuers, or how any such incorporation should be implemented. It added that additional analysis and consideration of the threshold policy question—
- the question of whether transitioning to IFRS is in the best interests of the U.S. securities markets generally and U.S. investors specifically—is necessary before any decision by the SEC can occur.
- SEC noted that feedback it received as it formulated the Work Plan indicated a large majority of constituents opposed a requirement to adopt the standards of the IASB outright.
- However, the staff said there is substantial support for exploring other methods of incorporating IFRS into U.S. GAAP and focused its efforts accordingly.

IFRS Foundation & Board

- Lets' take a look at the flowchart regarding IFRS foundation and board.



What is IASB?

- The IASB is a technical standard-setting body.Membership The IASB has up to 14 members (currently 11). The International Accounting Standards Board (IASB) is an independent, private-sector body that develops and approves International Financial Reporting Standards (IFRSs). The IASB operates under the oversight of the IFRS Foundation. The IASB was formed in 2001 to replace the International Accounting Standards Committee (IASC). A full history of the IASB and the
- IASC going back to 1973 is available on the IASB website.

- Currently, the IASB has 14 members.
- Most are full-time, so that they commit all of their time to paid employment as an IASB member.
- Up to three can be part-time, but they are expected to spend most of their time on IASB activities. All members of the IASB are required to commit themselves formally to acting in the public interest in all matters.
- Purpose of IASB
- Under the IFRS Foundation Constitution, the IASB has complete responsibility for all financial reporting-related technical matters of the IFRS Foundation including:
- full discretion in developing and pursuing its technical agenda, subject to certain consultation requirements with the Trustees and the public
- the preparation and issuing of IFRSs (other than Interpretations) and exposure drafts, following the due process stipulated in the Constitution
- the approval and issuing of Interpretations developed by the IFRS Interpretations Committee.

Qualifications of IASB Members

- Members are selected to ensure that at all times the IASB has the best available combination of technical expertise and diversity of international business and market experience to develop high
- quality, global financial reporting standards. Members include people who have experience as auditors, preparers, users, academics and market and/or financial regulators.
- The maximum term is 10 years—an initial term of five years and a second term of three to five years(five years for the Chair and Vice-Chair).

5.9 Role of European Union in Convergence of Accounting

The European Union is a unique economic and political partnership between 27 democratic European countries, What began as a small group of 6 nations in 1957 under the Treaty of Rome, has assumed great dimensions and aims at peace prosperity and freedom for its 495 million citizens in a fairer, safer world. The two main instruments employed by the EU to achieve the objective of convergence are: Directives and Regulations. Member states are required to incorporate the directives into their laws. They are binding on the member states to which they are addressed, as regards the ends. The member states are, however, given freedom with respect to the means to be adopted to achieve the desired ends. Regulations, on the other hand, do not need to pass through a national legislature and are binding in every respect through out the EU. The procedure adopted in setting a directive is fairly lengthy. The fourth and seventh directives are of relevance from the point of view of accounting and reporting. The fourth directive deals with the formats of published financial statements, the valuation rules and disclosure. requirements. The seventh directive deals with the issue of consolidation of financial statements. Both the fourth and seventh directives have been amended in 2006. The eighth directive addressed itself to the qualifications and work of auditors it has been replaced by the Directive on Statutory Audit of Annual Accounts and Consolidated Accounts which was issued in September 2006.The EU was the first major jurisdiction to make IFRS mandatory for its listed companies since 2005, thus setting the foundation for the success of these standards, and needless to say it remains by far the largest jurisdiction applying IFRS. In June 2000, the European Commission had adopted a 'financial reporting strategy'. To implement this strategy the EU in 2002 approved an Accounting Regulation requiring all EU companies listed on regulated markets to follow MRS in their consolidated financial statements starting in 2005. Commenting on this occasion the Internal Markets Commissioner Frits Bolkestein (EU, 2003) said, "Adoption by the Commission of this Regulation endorsing most Of the existing International Accounting Standards and publishing them in EU's official languages will help the 7000 or so EU listed companies affected to get ready for 2005, when their consolidated accounts will have to be in line with IAS. That will put an end to the current Tower of Babel in financial reporting, movement of capital much easier". In case of non-listed company's member states have the option to extend the IAS regulation to them and to the production of individual accounts. Non-

EU companies listed on regulated GAAPs pending the EC EU stock markets have been permitted to continue to use their national assessment of the equivalency of their national GAAP to IFRS. On 21 December 2007 the Commission adopted an "equivalence mechanism" in relation to third country GAAPs. Using the definition of equivalence and the mechanism established by the Regulation the Commission can present concrete proposals on which third-country GAAPs should be accepted as equivalent with effect from 2009. Where these countries are converging with IFRS or intend to adopt IFRS, the transitional period may be extended upto ending 2011 at the latest. Commenting on the occasion, European Internal Market and Services Commissioner McCreevy (Europa, 2008) said, "This is a crucial milestone towards our objective of promoting the efficiency of capital markets by establishing a common worldwide accounting language. Without this regulation in place we would. not be able to proceed with this key decision on the acceptability of third-country GAAPs in EU". The EU Accounting Regulation provides for individual endorsement of each IFRS for use in Europe. This is a long-drawn procedure. The standard has to be first translated into all relevant. European languages, examined and recommended by the European Financial Reporting Advisory Group (EFRAG), after which it is viewed by the Standards Advice Review Group (SARG). Finally, the EC's Accounting Regulatory Committee (ARC) makes an endorsement and submits it to the European Parliament's Regulatory Procedure with Scrutiny Committee and to the 27 member Council of the EU. Both must approve the endorsement. As regards enforcement of IFRSs in Europe the regulation of securities markets is left to individual member states subject to certain regulations adopted at the EU level, The EU-wide regulations include:

1) Standards adopted by the Committee of European Securities Regulators (CESR): The CESR is a consortium of national regulators, its Standard No. 1 relates to Enforcement of standards on financial information in Europe and set out 21 high level principles that EU member states should adopt in enforcing IFRSs. Guidelines for implementing these standards are contained in Standard No. 2—Coordination of Enforcement Activities.
2) The Directive on Statutory Audit of Annual Accounts and Consolidated Accounts was issued in financial information in Europe and set out 21 high level principles that EU member states should adopt in enforcing IFRSs. Guidelines for implementing these standards are contained in Standard No. 2—Coordination of Enforcement Activities.
3) The Directive on Statutory Audit of Annual Accounts and Consolidated Accounts was issued in September 2006. It replaces the eighth directive and amends the fourth and Seventh directives. There are two important provisions in this directive which will have companies. Firstly, the Directive has adopted International Standards of Auditing (ISAs) throughout EU and secondly, it requires Member States to form auditor oversight bodies. throughout EU oversight bodies. Consequently, the European Group of Oversight Bodies was formed in late 2005.
4) Amendments to EU directives that establish the collective responsibility of board members for the company's financial statements.To ensure effective, consistent application of IFRS, the EC formed a Roundtable for consistent application of IFRSs in 2006. The function of the Roundtable is to identify emerging and problematic accounting issues in the application of IFRS so that they may be brought to the notice of the IASB and IFRIC.

5.10 International Organization of Securities Commission

- The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulator and is recognized as the global standard setter for the securities sector.
- IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation.
- It works intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda.

- IOSCO was created in 1983, when 11 securities regulatory agencies from North and South America agreed to build their inter-American regional association into an international cooperative body.
- A year later, securities regulators from France, Indonesia, Korea and the United Kingdom become the first non-American agencies to join the new organization.
- In July 1986, IOSCO held its annual conference in Paris, the first outside the Americas and where members agreed to create a permanent General Secretariat.
- In 1987, the Government of Québec helped incorporate IOSCO as a not-for-profit legal entity under a private act in Québec, sanctioned by the Québec National Assembly.
- The same year IOSCO established the first Secretariat in Montreal and named Mr. Paul Guy, President of the CVMQ as its first Secretary General.
- The Secretariat remained in Montreal until 1999 when it was then moved to Madrid.
- In 1998 IOSCO adopted a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), now recognized as the international regulatory benchmarks for all securities markets.
- In 2003 the organization endorsed a comprehensive methodology (IOSCO Principles Assessment Methodology).
- IOSCO employs this methodology to conduct an objective assessment of the level of implementation of the IOSCO Principles in members' jurisdictions and to help develop practical action plans to correct identified deficiencies.
- In 2002, IOSCO adopted a Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information……
- (IOSCO MMoU), which was designed to facilitate cross-border enforcement and exchange of information among international securities regulators.
- In 2005, IOSCO endorsed the IOSCO MMoU as the benchmark for international cooperation among securities regulators, and laid down a clear strategy and the objectives for expanding the network of IOSCO MMoU signatories by 2010. A top priority for IOSCO is for its members to achieve the effective implementation of the IOSCO Principles and the MMoU, thereby facilitating cross-border cooperation, mitigating global systemic risk, protecting investors and ensuring fair and efficient securities markets.
- IOSCO was established in 1983. Its membership regulates more than 95% of the world's securities markets in more than 130 jurisdictions securities regulators in emerging markets account for 75% of its ordinary membership.
- The *IOSCO Objectives and Principles of Securities Regulation* have been endorsed by both the G20 and the FSB as the relevant standards in this area.
- They are the overarching core principles that guide IOSCO in the development and implementation of internationally recognized and consistent standards of regulation, oversight and enforcement.
- They form the basis for the evaluation of the securities sector for the Financial Sector Assessment Programs (FSAPs) of the International Monetary Fund (IMF) and the World Bank.
- By providing high quality technical assistance, education and training, and research to its members and other regulators, IOSCO seeks to build sound global capital markets and a robust global regulatory framework.

Objectives of International Organization of Securities Commission

- to cooperate in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight
- and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks;

- to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries
- to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

Role of United Nations in Harmonization

- The UN's role in harmonization of accounting practices has been rather limited. The list of financial and non-financial disclosures to be made by MNCs as suggested by its Group of Experts on International Standards of Accounting and Reporting in the year 1977 was not well accepted by most of the industrialized nations.
- The list of disclosures was comprehensive including information on transfer pricing, segment performance, R&D, employment.
- As most of these are considered as priority information which countries did not want to part with and as UN has no enforcing authority, its recommendation did not work.
- However, the UN's recent efforts in bringing harmony in international accounting practices in the line of IASC and environmental reporting has been seen as a success.
- The involvement of United Nation (UN) in this sphere is mainly restricted to disclosure of accounting and non-accounting information by MNCs.
- In 1973, the United Nations Economic and Social Council charged a 'Group of Eminent Persons' the task of advising on matters related to transnational corporations (TNCs) the official term for MNCs and their impact on the development process. This Group of Eminent Persons reported that, information (both financial and non-financial) about the activities of the MNCs was not easily available. Besides, even the annual reports which were available lacked comparability.
- The Group, therefore, recommended that a group of experts be brought together under the auspices of the Commission on Transnational Corporations to consider the formulation of an international system of standardized accounting and reporting. The UN Council established the Centre on Transnational Corporation in 1974, to assist the various groups working on the projects of the Commission. The Group of Experts on International Standards of Accounting and Reporting was created in 1976.
- The 14-member group included persons from diverse backgrounds. The Group submitted its report on International Standards of Accounting and Reporting for Transnational Corporations to the Secretary General of other UN in 1977. One of the important recommendations was that the UN set up a permanent accounting body to ensure that all transnational corporations (TNCs) use the same accounting standards and disclose financial and non-financial information.
- The accounting disclosures required related:
  - Financial statements relating to individual companies within a consolidated group including that of the parent as a separate entity
  - Information regarding segments both by line of business and geographic area
  - Information regarding a controversial area, i.e. transfer pricing policies.
- The report was not accepted mainly because the Group of Experts were not government representatives.
- In May 1979, the Commission, therefore, set up an ad hoc intergovernmental group of experts on accounting and reporting standards, selected by the member governments.
- This group was entrusted with the task of developing a comprehensive information system to determine the impact of the transnational corporations on home and host countries and a proposed code of conduct for the TNCs.
- The ad hoc group held six sessions between 1980 and 1982. It, however, failed to reach a consensus on many issues, and as a result the final report got delayed till late 1982.

- The Group, therefore, submitted an interim report in 1981 which endorsed a number of principles. First, for general-purpose reporting requirements, it agreed that the principle of non-discrimination between TNCs and national enterprises be observed. Second, that the concept of materiality ought to be kept in mind while defining the scope of disclosure. Third that the term 'company' be preferably replaced by 'enterprise'.
- The final report submitted in 1982 which incorporated much of the interim report, emphasized that:.
- The information needs of both host and home countries should be considered by TNCs when accounting and reporting.
- The information provided should be comparable.
- The cost of providing the information should be reasonable vis-i-vis the benefits to be derived from it.
- Business confidentiality should be given due consideration.
- Regarding disclosure of information, the principle of non-discrimination between domestic concerns and TNCs should be observed, keeping in mind the relevant provisions of the future code of conduct.
- One of the main recommendations of the ad hoc group was that the group be put on a more formal and effective basis by the creation of an intergovernmental expert group which would meet on a regular basis to fulfil a specific mandate.
- The Economic and Social Council, therefore, by a resolution, established the International Standards of Accounting and Reporting.
- The UN's involvement with the accounting and financial reporting standard-setting process was part of the regulatory process, on account of the economic threat posed to developing countries by the size of MNCs.
- The primary objective, therefore, was to protect the developing nations against the TNCs. Its endeavors in this direction were thwarted on account of the lack of information about the working of these….
- corporations, and it therefore focused its efforts on disclosure standards. The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) was established in 1982 with this broad objective in view.

Summary

The international convergence of accounting standards refers to the goal of establishing a single set of high-quality accounting standards to be used internationally, and the efforts of standard-setters towards achieving that goal. Convergence is taking place in various countries, with over 100 countries having made public commitments supporting convergence towards the International Financial Reporting Standards (IFRS). Efforts towards convergence include projects that aim to improve the respective accounting standards, and those that aim to reduce the differences between them. The convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. Convergence in some form has been taking place for several decades, and efforts today include projects that aim to reduce the differences between accounting standards. Convergence is driven by several factors, including the belief that having a single set of accounting requirements would increase the comparability of different entities' accounting numbers, which wil contribute to the flow of international investment and benefit a variety of stakeholders. Criticisms of convergence include its cost and pace,and the idea that the link between convergence and comparability may not be strong.

Keywords

- Harmonization: The process of combining national and worldwide accounting rules and practises to produce a single set of global standards.

- International Financial Reporting Standards (IFRS): These are a collection of accounting guidelines for public firms' financial statements that are meant to make them consistent, transparent, and easily compared around the world.
- The International Accounting Standards Board (IASB): It is a private-sector, independent group that develops and certifies International Financial Reporting Standards (IFRSs).

Self Assessment

1. Indian Accounting Standards are formulated by:

A. ASB
B. IASB
C. ICSI
D. ICMAI

2. Which of the following is not a level that can be used to define international accounting?

A. Supranational
B. company
C. comparative
D. none of the above

3. Due to harmonization of accounting practices

A. international accounting differences have all but disappeared
B. environmental factors still lead to diversity in practice
C. financial reporting is becoming simpler
D. all of the above

4. Which influences accounting systems at national level

A. taxation arrangement
B. political arrangement
C. capital market arrangements
D. all of the above

5. Which of the following is a significant barrier in adopting the international accounting standards in Islamic countries

A. the prohibition on charging interest
B. zakat
C. compartmentalized religion and secularized life
D. all of the above

6. Which of the following cannot be taken as a challenge for international business when faced with accounting diversity

A. costly to restate financial statements
B. reduced access to international investments
C. national accounting regimes are inferior to international accounting
D. they all are a challenge

7. The international accounting standard board's objective for international accounting standards would be best described as

A. adoption
B. harmonization

C. convergence
D. adaptation .

8. Which cannot be described as a disadvantage to IFRS adoption
A. cost effective
B. comparable financial statements
C. flexible accounting standard development
D. none of these

9. Which of the following can be considered as a significant difficulty in adoption of IFRS in certain countries
A. consolidation
B. fair value accounting
C. focus on profit
D. all of these

10. In China acceptance of international accounting standards is called
A. adoption
B. harmonization
C. convergence
D. indifference

11. Securities and Exchange Commission allows non-us companies which are listed on the Stock Exchange of US to present the reports applying
A. their own country standards
B. international accounting standards reconciled with US GAAP
C. international accounting standards
D. none of these

12. MNCs are
A. operate independently of the legal framework of any country
B. not affected by culture of individual countries
C. only use IFRS
D. none of these

13. iLASB was formed in
A. 2001
B. 2003
C. 2005
D. 2015

14. IASB is …..sector body
A. Private
B. Public
C. Mixed
D. Statutory

15. International accounting refers to

A. description of accounting practices in different countries
B. comparing accounting practices amongst countries
C. international transactions accounting
D. all of the above

Answers for Self Assessment

l.	A	2.	D	3.	B	4.	D	5.	A
6.	C	7.	A	8.	C	9.	D	10.	C
11.	C	12.	D	13.	A	14.	A	15.	D

Review Questions

1. What motivated the convergence of accounting standards?
2. What exactly is the distinction between IFRS adoption and IFRS convergence?
3. What is the term for converged IFRS?
4. What are the obstacles in adoption of international accounting standards?
5. Write a note on harmonization of account g standards?

Further Readings

A text book on International Accounting and Reporting Issues: 2018 Review by United Nations Conference on Trade and Development (UNCTAD) · 2019

A text book on Dual Reporting for Equity and Other Comprehensive Income by Francesco Bellandi

Web Links

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Unit 06: Comparative Financial Reporting

CONTENTS

Objectives

After studying this unit, you will be able to:

- comprehend the accounting standards as followed in US,
- Compare and contrast between US GAAP and IFRS.
- comprehend the accounting standards as followed in China,
- Compare and contrast between Chinese GAAP and IFRS.
- comprehend the accounting standards as followed in United Kingdom (UK),
- Compare and contrast between the UK GAAP and IFRS.
- comprehend the accounting standards as followed in Japan,
- Compare and contrast between Japanese GAAP and IFRS.

Introduction

Investors and financial analysts need to be able to understand the financial statements of foreign companies whose shares they might wish to buy. They would like to be sure that statements from different countries are reliable and comparable or at least to be clear about the differences. Generally Accepted Accounting Principles (GAAP) are a collection of commonly-followed accounting rules and standards for financial reporting. Investors' reliance on management-generated reports as their primary source of information is one shortcoming of the corporate control process. Managers may inflate their performance if they are working for themselves rather than the investors. There are numerous well-known instances (like Enron and WorldCom), in which significant multinational corporations (MNCs) were able to modify their financial reporting and conceal issues from investors. This section highlights different reporting practices of US,UK, China and jAPAN

6.1 US GAAP

- Generally Accepted Accounting Principles (GAAP or US GAAP) are a collection of commonly-followed accounting rules and standards for financial reporting.
- The specifications of GAAP, which is the standard adopted by the U.S. Securities and Exchange Commission (SEC), include definitions of concepts and principles, as well as industry-specific rules.
- The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another.
- GAAP is merely a set of standards. Although its principles work to improve the transparency in financial statements, they do not provide any guarantee that a company's financial statements are free from errors or omissions that are intended to mislead investors.
- The Securities and Exchange Commission (SEC) has stated that it intends to move from GAAP to the International Financial Reporting Standards (IFRS).
- But the latter differ considerably from GAAP and progress toward adoption or convergence has been slow.
- While GAAP itself is not government-regulated, it exists because of the combined efforts of government and business.
- The use of GAAP is not mandatory for all businesses, but SEC requires publicly traded and regulated companies to follow GAAP for the purpose of financial reporting.
- Companies that issue stock are held to this standard by Securities and Exchange Commission (SEC), which requires yearly external audits by independent accountants,but companies without external investors are not obliged to follow this standard.
- Despite the mandate, the SEC is not responsible for the standards associated with GAAP.
- Instead, the Financial Accounting Standards Board (FASB) actively influences any changes in financial reporting standards used at the corporate level.
- The FASB Advisory Council (FASAC) advises the FASB on all matters that may influence GAAP rules.
- Government entities, on the other hand, are influenced by a set of standards that are slightly different from GAAP. The Government Accounting Standards Board (GASB) manages those standards.
- Other countries have their own GAAP rules, which differ from those in the United States. Each country's own version of the FASB, such as the Canadian Institute of Chartered Accountants (CICA), creates these rules.
- In 2008, the Securities and Exchange Commission issued a preliminary "roadmap" that may lead the United States to abandon GAAP in the future, andto join more than 100 countries around the world in using the London-based International Financial Reporting Standards (IFRS).
- If a company distributes its financial statements outside of the company, GAAP must be followed.
- If a corporation's stock is publicly traded, financial statements must also adhere to rules established by the U.S. Securities and Exchange Commission.

- GAAP addresses such things as revenue recognition, balance sheet, item classification, and outstanding share measurements.
- If a financial statement is not prepared using GAAP, investors should be cautious. Also, some companies may use both GAAP- and non-GAAP-compliant measures when reporting financial results.
- GAAP regulations require that non-GAAP measures are identified in financial statements and other public disclosures, such as press releases.

6.2 IFRS

- These are a set of international accounting standards, which state how particular types of transactions and other events should be reported in financial statements.
- IFRS are issued by the International Accounting Standards Board (IASB), and they specify exactly how accountants must maintain and report their accounts.
- IFRS was established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country.
- More than 144 countries around the world have adopted IFRS, which aims to establish a common global language for company accounting affairs.
- While the Securities and Exchange Commission (SEC) has openly expressed a desire to switch from GAAP to IFRS, development has been slow.
- The point of IFRS is to maintain stability and transparency throughout the financial world. IFRS enables the ability to see exactly what has been happening with a company and allows businesses and individual investors to make educated financial decisions.
- IFRS is standard in the European Union (EU) and many countries in Asia and South America, but not in the United States.
- The Securities and Exchange Commission won't switch to International Financial Reporting Standards in the near term but will continue reviewing a proposal to allow IFRS information to supplement U.S. financial filings.

6.3 Key Differences between IFRS vs. US GAAP

1. Adoption**:** IFRS is a globally adopted method for accounting, while GAAP is exclusively used within the United States.

2.Methodology**:** GAAP focuses on research and is rule-based, whereas IFRS looks at the overall patterns and is based on principle.

3. Developed by **:** The principles of IFRS are issued by the International Accounting Standard Board (IASB), while GAAP are issued by Financial Accounting Standard Board (FASB)

4. The Balance Sheet: The way a balance sheet is formatted is different in the US than in other countries. Under GAAP, current assets are listed first, while a sheet prepared under IFRS begins with non-current assets.The two standards also dictate different approaches to ordering categories on the balance sheet. GAAP calls for accounts to be listed in the order of liquidity—or how quickly and easily theycan be converted to cash. The items are arranged in descending order (most liquid to least liquid): current assets, non-current assets, current liabilities, non-current liabilities, and owners' equity.Under IFRS, the order is reversed (least liquid to most liquid): non-current assets, current assets, owners' equity, non-current liabilities, and current liabilities.

5. Classification of liabilities**:** When preparing financial statements based on the GAAP accounting standards liabilities are classified into either current or non-current liabilities, depending on the duration allotted for the company to repay the debts.

Debts that the company expects to repay within the next 12 months are classified as current liabilities, while debts whose repayment period exceeds 12 months are classified as long-term liabilities.

However, there is no plain distinction between liabilities in IFRS, so short-term and long-term liabilities are grouped together.

6. Intangibles: The treatment of developing intangible assets through research and development is also different between IFRS vs US GAAP standards.

Under IFRS, costs in the research phase are expensed as incurred. Costs in the development phase may be capitalized based on certain factors.

On the other hand, US GAAP generally requires immediate expensing of both research and development expenditures, although some exceptions exist.

7. Fixed assets: Companies using GAAP accounting must value these assets using the cost model. IFRS uses a different model for fixed assets called the revaluation model.

8. Rules vs. Principles: The other distinction between IFRS and GAAP is how they assess the accounting processes – i.e., whether they are based on fixed rules or principles that allow some space for interpretations.

Under GAAP, the accounting process is prescribed highly specific rules and procedures, offering little room for interpretation.

The measures are devised as a way of preventing opportunistic entities from creating exceptions to maximize their profits.

On the contrary, IFRS sets forth principles that companies should follow and interpret to the best of their judgment. Companies enjoy some leeway to make different interpretations of the same situation.

9. Recognition of revenue: With regards to how revenue is recognized, IFRS is more general, as compared to GAAP. The latter starts by determining whether revenue has been realized or earned, andit has specific rules on how revenue is recognized across multiple industries.

The guiding principle is that revenue is not recognized until the exchange of a good or service has been completed. Once a good's been exchanged and the transaction recognized and recorded, the accountant must then consider the specific rules of the industry in which the business operates.

Conversely, IFRS is based on the principle that revenue is recognized when the value is delivered.

It groups all transactions of revenues into four categories, i.e., the sale of goods, construction contracts, provision of services, or use of another entity's assets.Companies using IFRS accounting standards use the following two methods of recognizing revenues:

Recognize revenues as the cost that can be recovered during the reporting period.

For contracts, revenue is recognized based on the percentage of the whole contract completed, the estimated total cost, and the value of the contract.

The amount of revenue recognized should be equal to the percentage of work that has been completed.

10. Income Statement: Extraordinary or unusual items are included in the income statement and not segregated under IFRS. While, under GAAP, they are separated and shown below the net income portion of the income statement.

11. Treatment of inventory: One of the key differences between these two accounting standards is the accounting method for inventory costs.

Under IFRS, the LIFO (Last in First out) method of calculating inventory is not allowed. Under the GAAP, either the LIFO or FIFO (First in First out) method can be used to estimate inventory.

The reason for not using LIFO under the IFRS accounting standard is that it does not show an accurate inventory flow and may portray lower levels of income than is the actual case.

On the other hand, the flexibility to use either FIFO or LIFO under GAAP allows companies to choose the most convenient method when valuing inventory.

12. The Cash Flow Statement: A company's cash flow statement is also prepared differently under GAAP and IFRS. This is most acutely seen in how interest and dividends are classified.

GAAP prescribes that interest paid and interest received should be classified as operating activities, while international standards are a bit more flexible.

Under IFRS, a firm can choose its own policy for classifying interest based on what it considers to be appropriate. Interest paid can be placed in eitherthe operating or financing section of the cash flow statement, and interest received in the operating or investing sections.

The same goes for dividends. GAAP specifies that dividends paid be accounted for in the financing section, and dividends received in the operating section.

When following IFRS standards, companies have a choice of how they categorize dividends. Dividends paid can be put in either the operating or financing section, and dividends received in the operating or investing section.

13. Development costs**:** These can be capitalized under IFRS, as long as certain criteria are met. With GAAP, development costs are not allowed to be capitalized.

14. Quality Issues**:** Finally, the qualitative characteristics of how the accounting methods function. GAAP uses a hierarchy of characteristics, such as relevance, reliability, comparability and understandability to make informed decisions based on user-specific circumstances. IFRS also works with the same characteristics, except that decisions cannot be made based on an individual's specific circumstances.

6.4 Chinese Accounting Standard

- In China, the Accounting Regulatory Departmentof the Ministry of Finance (MoF) is the authorityresponsible for setting out the country's accounting standards.
- Since 1992 the Chinese Ministry of Finance has worked on the gradual implementation of the Chinese Generally Accepted Accounting Principles, or China GAAP, also known as the Chinese Accounting Standards.
- Chinese Accounting Standards mainly consistout of two sets of accounting standards, namely
- 1) the Accounting Standards for Business Enterprises (ASBEs) and
- 2) the Accounting Standards for Small-Sized Business Enterprises (ASSBEs).
- The ASBEs consist of one Basic Standard, 38 Specific Standards and the related application guidance, which provide the Chinese conceptual framework for financial reporting which applies to all enterprises established in Mainland China, andcan be viewed as the counterpart of the International Financial Reporting Standards (IFRS). Whereas the ASBEs have been commonly adopted by most enterprises in China either on a compulsory or voluntary basis by since their issuance in 2006, small-scale enterprises may choose to adopt instead the ASSBEs (the counterpart of IFRS for SMEs).
- Since the purpose of accounting is to provideinformation to truthfully reflect the financial situation and operating results of an enterprise, theChinese Accounting Standards stipulate that for-profit enterprises should perform their accounting based on an accrual basis.

6.5 Key Differences Between Chinese Accounting Standard and IFRS

- CAS and the IFRS are generally convergent with each other, they are still slightly different in some respects.
- 1.Valuation methods for fixed assets - Under the IFRS, one may choose the valuation method for certain types of fixed assets.
- The company can value these assets either using the historical cost principle or by applying a revaluation of assets.
- Chinese Accounting Standards however only allow fixed assets to be valued according to their historical cost.
- 2. More detailed rules in CAS - For certain items that are common in China, the CAS has more detailed rules than the IFRS.
- An example would be the merging of two companies controlled by the same entity and having similar interests.
- CAS requires that the comparative figures be restated, whereas there is no specific rule for this in the IFRS.
- 3. More detailed rules in IFRS - IFRS have rules for situations that are uncommon in China, such as more detailed employee benefit plans. Apart from paying employees with company stock,
- CAS does not address certain types of employee benefits commonly offered by multinationals. However, for certain items that are common in China, the CAS has more detailed rules than the IFRS.
- An example would be the merging of two companies controlled by the same entity and having similar interests. CAS requires that the comparative figures be restated, whereas there is no specific rule for this in the IFRS.
- Difficulties can arise when the parent company attempts to translate such a package to its Chinese subsidiary. In this case, the company may need to consult with the Ministry of Finance as to how these transactions should be recorded.
- 4. Delayed implementation of IFRS - When new updates to the IFRS are released, the MOF first reviews them to determine whether the new rules are appropriate for China and whether it will decide to incorporate them CAS.
- As a result, the adoption of new IFRS standards is often delayed or does not happen at all. This can lead to further divergence if the countries where other entities of the corporate group are established adopt the new IFRS rules earlier.
- 5. Fiscal Year**:** In line with the Chinese Accounting Standards, the fiscal year in China must start from January 1st and no exceptions are provided.
- On the other hand, according to IFRS the company's fiscal year can start at any point throughout the year provided that it encompasses a period of 12 consecutive months.
- After the end of the Chinese fiscal year all foreign-invested enterprises in China must complete theannual statutory requirements, including the year-end statutory audit, annual CIT filing and annual publication report.
- As a consequence of the fiscal year end date, the deadline for the above statutory requirements is May 31st of the subsequent year.
- 6. Tax Filing**:** Whereas in China companies submit financial statements on a monthly basis, under IFRS returns can be filed on a quarterly or bi-monthly basis.
- 7. Classification of Expenses**:** The Chinese Accounting Standards stipulate that expenses are classified according to function, whereas IFRS would classify said expenses by nature.
- 8. Other differences**:** Furthermore, it should be noted that the Chinese Accounting Standards contain standards for dealing with accounting matters concerning situations specific to China.

- An example would be that upon a merger between two entities which are controlled by the same entity are required to restate its accounting figures.Conversely, IFRS may provide more guidance anddetails regarding situations less common in China.
- One major difference is the principles concerning employee benefits, where the Chinese Accounting Standards are fairly limited in addressing different types of employee benefits offered by international companies with the notable exception of company stock options.
- It should be further noted that the ASBEs have notbeen revised since their issuance in 2006, where only interpretations to IFRS changes have been issued to provide authoritive guidance, andas a result we can conclude that the Chinese Accounting Standards are characterized by a delayed implementation of updates to the IFRS.
- Thus, foreign-invested enterprises with a Chinese subsidiary can expect some divergence between their subsidiary in China and other international subsidiaries.

6.6 Mapping: Converting Chinese Financial Reports

- The problem of differing accounting standards is most visible when an overseas parent company requests financial information from its Chinese subsidiary.
- As the two companies are required by law to follow different standards, the information from the Chinese subsidiary needs to be 'translated' to fit into the overseas parent company's books, in a procedure known as 'mapping'.
- Larger multinationals tend to have specialized software for assisting the corporate group with this process, but as this software tends to be very expensive, SMEs often need to do their conversions manually.

There are two major points a company needs to be aware of when 'mapping' its books:

- The first is the divergence of accounting rules between Chinese and international accounting standards, as discussed previously.
- Whether performed in-house or outsourced to a trusted advisor, the company's accountant needs to take a detailed look at the differences between the CAS and the target accounting system,as well as explore whether any of the firm's activities are affected, often spending several days in the process. If outsourcing accounting work, it is important to notify your accountant of the need totranslate your accounts as soon as possible and ensure that this information is shared throughout the company. If the accountant only learns of this request later, this may significantly delay the process.
- The second is the difference in accounting entry codes. Conversion is a one-time procedure that the outsourced accountant needs to complete when first contracted by a new company.
- Once the accountant determines which Chinese entry matches which foreign entry, these figures can be automatically converted.

6.7 Conceptual Framework of UK GAAP and IFRS

IFRS :

- Qualitative characteristics split into fundamental and enhancing.
- Two main measurement bases are permitted: historical cost and current value.
- The current value can be one of the following:
    - Fair value
    - Value in use (or fulfilment value for liabilities)
    - Current cost

UK GAAP:

- Only one tier of qualitative characteristics

- Only two measurement bases (cost and fair value)

Key difference between UK GAAP and IFRS

1. Primary financial statements**:** The primary difference is related to the terminology of financial statements between these standards
2. IFRS **:** Terminology: Statement of Financial Position, Statement of Profit or Loss & Retained Earnings. Other comprehensive income
3. UK GAAP**:** Balance Sheet/Statement of financial position, Profit and loss account/Income statement & Profit and loss account (reserve)
4. InventoryMeasurement**:** Under UK GAAP, Inventories held for distribution at no or nominal consideration are measured at adjusted cost.Additional guidance is provided on what should be included in production overheads. Under IFRS, IAS 2 has no such requirement.
5. **Events after the Reporting Period:** The difference primarily relates to dividend disclosure. **IFRS:** Under IAS 10, Dividends declared after the year-end are not recognized but disclosed in the notes.UK GAAP**:** Dividends declared after the year-end are not a liability but may be presented as a separate part of equity.
6. Leases: IFRS 16 does not, for lessees, distinguish between finance and operating leases but requires nearly all leases to be recognized in the statementof financial position. There are exemptions for short leases and leases of low-value assets.
7. UK GAAP**:** FRS 102 makes a distinction, for lessees, between finance leases (substantially all the risks and rewards of ownership transferred) and operating leases (all other leases).
8. Discontinued Operations & Assets Held For Sale**:** IFRS**:** Discontinued operations are presented as a single line in SPL. The analysis appears in a note or statements of comprehensive income. Assets are classified as 'held for sale if they meet the criteria.UK GAAP**:** Discontinued operations are presented in a separate column from continuing operations. No equivalent concept, so it continues to depreciate until the sale.
9. The Effects of Change in Foreign Exchange Rates:
   IFRS: Under IAS 21, Cumulative foreign exchange differences are shown as a separate equity component.UK GAAP**:** No such requirement.
10. Borrowing Costs:IFRS**:** IAS 23 requires capitalization of borrowing costs when criteria are met.UK GAAP**:** Entities can choose whether to capitalize borrowing costs or recognize them as an expense incurred.
11. Intangible Assets:Development Expenditure: Under IAS 38, it's mandatory to capitalize on development expenditure when criteria are met. , while under UK GAAP, there is an option to capitalize on development expenditure
12. Useful lives: IAS 38 permits both intangible assets with finite and indefinite useful lives. In UK GAAP, All intangible assets have a finite useful life.It should be at most ten years if no reliable estimate can be made.
13. Goodwill**:** Under IFRS, goodwill is not amortized. However, it is subject to an annual impairment review. Under FRS 102, goodwill is amortized on a systematic basis throughout its expected life. If it can't be measured reliably, that expectancy should be no more than 10 years.
14. Property**:** Under FRS 102, users can decide to either capitalize or expense the borrowing costs related to acquiring or building property, whereas, under IFRS, the costs are always capitalized. When it comes to property investment, meanwhile, IFRS allows the business

to choose between holding it at depreciated cost or fair value. FRS 102, meanwhile, dictates that all property investments must be measured at fair value.

15. Purchases**:** The IFRS standard declares that all purchases that are incremental costs of obtaining a contract are classed as assets and amortized. The FRS 102 standard, meanwhile, declares that purchases are recognized according to the relatable period. So, for example, if commission was paid to an employee, this should be recognized during the month the commission was earned.

16. Revenue:Under FRS 102, revenue is recognized only when costs can be reliably measured and it's likely that the business will benefit economically. Under IFRS, meanwhile, revenue is recognized over time.

17. Disclosures:

18. For small businesses, using the FRS 102 standard allows them to use the small companies' regime, which lets them prepare accounts with certain reduced disclosures. Under IFRS, meanwhile, there are no exemptions for reduced disclosures.

6.8 Japanese Accounting Standard

- In Japan, movement towards IFRS adoption has significantly progressed. Although there are still a number of differences between Japanese GAAP (JGAAP) and IFRS, Convergence based on the "Tokyo Agreement" is ongoing and as revisions continue to be made to JGAAP.
- The Financial Services Agency of Japan outlined a proposed road map for adopting IFRS in
2009 and this started the consideration of IFRS adoption in earnest.
- Now in Japan, listed companies and certain other companies may adopt IFRS on a voluntary basis for their consolidated financial statements instead of using JGAAP (or US GAAP if that had been used).
- As of October 2021, 256 Japanese companies have either adopted or decided to adopt IFRS, and the number of adopters is increasing.
- With regard to Japanese GAAP, standards also continues to be developed in a way consistent with IFRS and other international accounting standards, for example in the areas of leases and impairment of financial instruments.
- As such it is important to update the latest developments of IFRS not only for voluntary adopters of IFRS but for all parties involved in financial reporting in Japan.

6.9 Key differences between Japanese GAAP and IFRS

1. Adoption: IFRS is a globally adopted method for accounting, while JGAAP is exclusively used within Japan
2. Methodology**:** JGAAPfocuses on rule, whereas IFRS is based on principles.
3. Focus**:** JGAAP emphasizes on current income (Income from beginning to the end of a term) IFRS emphasizes on comprehensive income (current income + other income)
4. Presentation of Financial Statements, AccountingPolicies, Changes in Accounting Estimates andErrors, Assets Held for Sale and DiscontinuedOperations
5. Presentation of Financial Statements, Accounting Policies, Changes in Accounting Estimates and Errors, Assets Held for Sale and DiscontinuedOperations

    - Components of financial statements: Under JGAAP The following statements (*1)must be prepared:
        - Consolidated Balance Sheet

- Statement of Consolidated
- Comprehensive Income (a single statement approach)
- or an Income Statement and a Statement of Other Comprehensive Income (a two statement approach)
- Consolidated Statement ofChanges in Shareholders' EquityConsolidated Cash Flow StatementsConsolidated Supplementary Information

Under IFRS The following statements must be prepared:

- Statement of Financial Position
- Statement of Comprehensive Income (a single statement approach)
- or an Income Statement and a Statement ofOther Comprehensive Income (a two statement approach)
- Statement of Changes in Equity
- Statement of Cash Flows
- Accounting Policies and Other Explanatory Information

6. Presentation sequence of current and non-currentitems**:** As per JGAAP assets and liabilities arepresented in order of liquidity, except for certain specified businesses.As per IFRS there is no explicit guidance for presentation sequence of current and non-currentitems.
7. Non-current assets classified as held for sale (and disposal groups): As per JGAAP **t**here are no specific rules.

Summary

The governments world wide has created an accounting framework to help its economic growth in keeping with the recent openness of its economy to global investment. The Generally Accepted Accounting Principles are frequent names for the local accounting framework . Foreign investors must be aware of a number of fundamental distinctions even if the national Accounting Standards maintain a high level of integration with internationally recognised accounting standards, such as IFRS. Since all foreign-invested firms are required to comply with monthly, quarterly, and annual compliance standards, this is very important.

Keywords

GAAP: The term "GAAP" (generally accepted accounting principles) refers to a set of widely used standards and accounting procedures for financial reporting. Gap is how the acronym is pronounced. Definitions of concepts and guiding principles are included in GAAP specifications, along with industry-specific regulations. The goal of GAAP is to guarantee transparent financial reporting across public organisations as well as from one accounting period to the next.

IFRS: International Financial Reporting Standards (IFRS) are a collection of accounting guidelines for public firms' financial statements that are designed to make them uniform, transparent, and simple to compare globally. The European Union is one of the 167 jurisdictions for which IFRS currently has complete profiles. A distinct approach, known as generally accepted accounting principles (GAAP), is utilised in the United States.

Answers for Self Assessment

1. In ……, the SEC began permitting foreign private issuers to file IFRS financial statements without reconciliation to US GAAP.

A. 2007

B. 2020

C. 2021

D. 2022

2. IFRS ……… deals with First-time Adoption of International Financial Reporting Standards

A. 1

B. 2

C. 3

D. 4

3. Which of the following statements is true?

As a result of the UK's withdrawal from the EU, UK companies :

A. should apply UK-adopted international accounting standards (UK-adopted IAS) rather than EU IFRS for financial years beginning on or after 31 December 2020.

B. should not apply UK-adopted international accounting standards (UK-adopted IAS) rather than EU IFRS for financial years beginning on or after 31 December 2020.

C. should apply US-adopted international accounting standards (US-adopted IAS) rather than EU IFRS for financial years beginning on or after 31 December 2020.

D. should apply UK-adopted international accounting standards (UK-adopted IAS) rather than EU IFRS for financial years beginning on or before31 December 2020.

4. Which of the following statements is false in regard toUS?

A. Substantial convergence of selected standards.

B. Permitted for foreign private issuers preparing financial statements in accordance with IFRS as issued by the IASB.

C. There is no endorsement process in the US.

D. There is endorsement process in the US.

5. Which of the following statements is false in regard to JAPAN convergence with IFRS?

A. Mandatory adoption has been put on hold for the long time.

B. Permitted for most companies that are listed on a domestic stock exchange

C. Permitted for most companies that are planning to be listed on a domestic stock exchange

D. Mandatory adoption has been put on hold for the time being.

6. Which of the following is wrong about the difference between IFRS and US GAAAP?

A. Under IFRS, the LIFO (Last in First out) method of calculating inventory is not allowed. Under the GAAP, either the LIFO or FIFO (First in First out) method can be used to estimate inventory.

B. Under IFRS, costs in the research phase are expensed as incurred. On the other hand, US GAAP generally requires immediate expensing of both research and development expenditures, although some exceptions exist.

C. Under GAAP, the accounting process is prescribed highly specific rules and procedures, offering little room for interpretation. On the contrary, IFRS sets forth principles that companies should follow and interpret to the best of their judgment.
D. With regards to how revenue is recognized, GAAP is more general, as compared to GAAP. GAAP is based on the principle that revenue is recognized when the value is delivered

7. Which of the following is wrong about the difference between IFRS and UK GAAAP?
A. Under IFRS current value can be one of the following: Fair value, value in use (or fulfilment value for liabilities),Current cost whereas in UK GAAP only two measurement bases (cost and fair value) are available
B. Under IFRS Qualitative characteristics split into fundamental and enhancing whereas under UK GAAP Only one tier of qualitative characteristics is used
C. Under IFRS Statement of Financial Position, Statement of Profit or Loss & Retained Earnings,Other comprehensive income **terminologies used whereas under UK GAAP** Balance Sheet/Statement of financial position, Profit and loss account/Income statement & Profit and loss account (reserve) used
D. Under UK GAAP, Inventories held for distribution at no or nominal consideration are measured at adjusted cost. Additional guidance is provided on what should be included in production overheads. Under IFRS, IAS 2 has such requirement.

8. Which of the following is wrong about the difference between IFRS and UK GAAAP?
A. Under **IFRS,** Discontinued operations are presented as a single line in SPL. The analysis appears in a note or statements of comprehensive income. Assets are classified as 'held for sale if they meet the criteria. Under UK GAAP, Discontinued operations are presented in a separate column from continuing operations.
B. IFRS 15 adopts a five-step approach to revenue recognition. FRS 102 does not contain the five-step approach.
C. Under IAS 21, Cumulative foreign exchange differences are shown as a separate equity component. UK GAAP: There is also such requirement.
D. IAS 23 requires capitalisation of borrowing costs when criteria are met.UK GAAP: Entities can choose whether to capitalise borrowing costs or recognise them as an expense incurred.

9. Which of the following is wrong about the difference between IFRS and China GAAAP?
A. The most notable difference between Chinese GAAP and IFRS is that in line with the Chinese Accounting Standards companies can only use the historical cost method to valuate fixed- and intangible assets, whereas IFRS allows the use of both the historical cost method and the possibility of re-evaluating the asset(s).
B. In line with the Chinese Accounting Standards, the fiscal year in China must start from January 1st and no exceptions are provided. On the other hand, according to IFRS the company’s fiscal year can start at any point throughout the year provided that it encompasses a period of 12 consecutive months.
C. Chinese Accounting Standards contain standards for dealing with accounting matters concerning situations specific to China.Conversely, IFRS may provide more guidance and details regarding situations less common in China.
D. Whereas in China companies submit financial statements on a bi-monthly basis, under IFRS returns can be filed on a quarterly or monthly basis.

10. The Chinese Accounting Standards stipulate that expenses are classified according to …..

A. Function
B. Nature
C. Both
D. None of these

11. IFRS would classify expenses by ……..
A. Function
B. Nature
C. Both
D. None of these

12. In line with the Chinese Accounting Standards, the fiscal year in China must start from….
A. Jan 1
B. April 1
C. at any point throughout the year
D. Oct 1

13. In line with the IFRS, the fiscal year must start from….
A. Jan 1
B. April 1
C. at any point throughout the year
D. Oct 1

14. Under IFRS returns can be filed on a
A. Quarterly or bi-monthly basis.
B. Monthly basis
C. Only Quarterly
D. Only Bi-Monthly

15. Chinese Accounting Standards companies can only use …… method to valuate fixed- and intangible assets
A. historical cost method
B. both the historical cost method and the possibility of re-evaluating the asset
C. Fair value
D. None of these

Answers for Self Assessment

l.	A	2.	A	3.	A	4.	D	5.	D
6.	D	7.	D	8.	C	9.	D	10.	A
11.	B	12.	A	13.	C	14.	A	15.	A

Review Questions

1. Compare and contrast between US GAAP and IFRS.
2. comprehend the accounting standards as followed in China,
3. Compare and contrast between Chinese GAAP and IFRS.
4. Compare and contrast between the UK GAAP and IFRS.
5. Compare and contrast between Japanese GAAP and IFRS.

Further Readings

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Unit 07: International Transfer Pricing

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the conceptual framework of transfer pricing
- explain the significance of transfer pricing worldwide
- discuss the applicability of transfer pricing in India and Overseas
- explain the different methods of Transfer Pricing and their benefits to a business
- discuss the preconditions for the effective implementation of each method of Transfer Pricing
- explain the challenges in the successful adoption of any Transfer Pricing method

Introduction

Previously, transfer pricing laws were exclusively applicable to international transactions.The scope of Transfer Pricing laws is extended to 'Specified Domestic Transactions' with effect from 01.04.2013 and is thus effective from A.Y. 2013-14.With the application of Transfer Pricing laws to Specified Domestic Transactions, it is now the taxpayer's responsibility to report/document and justify the Arm's Length nature of such transaction. International Transfer Pricing existed in both industrialised and developing countries around the world. When other developing countries, such as Korea in 1998 and China in 1999, implemented Transfer Pricing, India did so in 2001. Now comes the question of why and what made Transfer Pricing necessary. Over 100 countries have implemented both international and domestic transfer pricing provisions.

7.1 Defining Transfer Pricing

- Transfer pricing can be defined as the value which is attached to the goods or services transferred between related parties.
- In other words, transfer pricing is the price that is paid for goods or services transferred from one unit of an organization to its other units situated in different countries (with exceptions).
- It is an accounting practice that represents the price that one division in a company charges another division for goods and services provided.
- It allows for the establishment of prices for the goods and services exchanged between subsidiaries, affiliates, or commonly controlled companies that are part of the same larger enterprise.

Objectives of Transfer Pricing

1. Generating separate profit for each of the divisions and enabling performance evaluation of each division separately.
2. Transfer prices would affect not just the reported profits of every center, but would also affect the allocation of a company's resources (Cost incurred by one center will be considered as the resources utilized by them).

Significance of Transfer Pricing

For management accounting and reporting, multinational companies (MNCs) have some amount of discretion while defining how to distribute the profits and expenses to the subsidiaries located in various countries.

Sometimes a subsidiary of a company might be divided into segments or accounted for as a standalone business. In these cases, transfer pricing helps in allocating revenue and expenses to such subsidiaries in the right manner.

The profitability of a subsidiary depends on the prices at which the inter-company transactions occur. These days inter-company transactions are facing increased scrutiny by the governments.

Here, when transfer pricing is applied, it could impact shareholders wealth as this influences company's taxable income and its after-tax free cash flow.

It is important that a business having cross-border intercompany transactions should understand the transfer pricing concept, particularly for the compliance requirements as per law and to eliminate the risks of non-compliance.

Transfer pricing can lead to tax savings for corporations, though tax authorities may contest their claims.

It refers to methods that determine the price for trading in goods or services between related enterprises or companies.

It enables improvements in pricing, brings in efficiency, and helps simplification of the process of accounting.

Benefits of Transfer Pricing

1. It enables savings in the costs of manpower by streamlining processes and methods.
2. It helps in achieving higher profitability and also focuses on strategizing business operations.
3. Transfer pricing helps in maintaining a market for the goods manufactured by a subsidiary with steady margins. It also helps in securing a steady supply of raw materials or components to the parent and facilitates continuous production.

4. The prices fixed for transferring goods is generally closer to the fair market price for such goods in the market.

Challenges of Transfer Pricing

1. The system of transfer pricing is between related enterprises. Hence, it is not beneficial to sell below or above the market price of either entities or the group as a whole.
2. If the goods are sold above or below the market price, it will lead to an uneven distribution of profits between different entities within a group.

Modus Operandi of Transfer Pricing

The arrangement may be between two or more subsidiaries of the parent company, or between different companies within a group.

For example, a parent company may manufacture the cars, including assembling the body and finishing the job.

- Two wholly-owned subsidiaries manufacture components, such as brake lining and others.
- Transfer pricing helps in determining the pricing of the components between the parent company and its subsidiaries.

7.2 Transactions Subject to Transfer Pricing

- Sale of finished goods
- Purchase of raw material
- Purchase of fixed assets
- Sale or purchase of machinery etc.
- Sale or purchase of intangibles
- Reimbursement of expenses paid/received
- IT enabled services
- Support services
- Software development services
- Technical Service fees
- Management fees
- Royalty fees
- Corporate Guarantee fees
- Loan received or paid

7.3 Limitations of Transfer Pricing

1. There could be differences in opinions among organizational divisional managers with respect to how the transfer price needs to be set.
2. 2. Additional time, costs, and manpower would be required for executing the transfer prices and designing the accounting system to match the requirements of transfer pricing rules.
3. Arm's length prices might cause dysfunctional behaviour among the managers of organizational units.

4. For some of the divisions or departments, for instance, a service department, arm's length prices don't work equally well as such departments don't offer measurable benefits.

7.4 Transfer Pricing in India

- TP Regulations were first introduced in 2001, as a measure against tax avoidance. The Indian TP Regulations are largely influenced by the said OECD TP Guidelines, but they are modified to specifically meet the needs of the Indian tax regime.
- Similar to the OECD Guidelines and TP Regulations of several other countries, Indian TP Regulations prescribe methods to compute 'Arm's Length Price' for an 'International Transaction' or a 'Specified Domestic Transaction' entered into by a taxpayer with its 'Associated Enterprise'.
- Section 92 of the Income tax Act, 1961 provides for the authority to an assessing officer to determine the profit which may be reasonably be deemed to have been derived from a transaction.
- This would be applicable where controlled Companies (associated enterprises) arrange the business between them in a way that either no profit is earned from such transaction or profit earned is lower than what would be expected in a transaction between uncontrolled Companies (unrelated entities).

Arm's Length Price (ALP)

It has been defined to be the price, which is applied or is proposed to be applied in a transaction between persons other than Associated Enterprises in uncontrolled conditions.

Domestic transfer pricing till March 2013,

The transfer pricing provisions were limited to international transactions alone. Since April 2013, Transfer Pricing provisions have been extended to SDTs (Specified Domestic Transactions) and are applicable from the assessment year 2013-14.

Transactions under Domestic Transfer Pricing

- Includes Expenditures in which payment has been made or would be made to a director, a relative of the director, or an entity where a director or the company has the voting interest exceeding 20%.
- Transactions that relate to the transfer of goods or services provided in Section 80-IA (8) & (10) (i.e., deductions which are related to profits and gains from enterprises engaged in infrastructure development or industrial undertakings, producers and distributors of power or Telecommunication Service Providers).
- SDT is also applicable to the transactions between the entity located in a tax holiday area and the one which is situated in a non-tax holiday area in case both are under the same management structure.
- For undertakings that are established in SEZs (special economic zones), free trade zone, or EOUs (export-oriented units) involving the transfer of goods and services to another unit under the same management at non-market prices.
- The above transactions would be treated as Specified Domestic Transactions only if the aggregate value of such transactions exceeds INR 5 crore.
- Transfer pricing law in India applies to both domestic and international transactions which fall above a threshold in terms of deal value.

- Transfer Pricing was introduced by inserting Section(s) 92A-F and relevant Rule(s) 10A-E of the Income Tax Rules 1962.
- It ensures that the transaction between 'related' parties is at a price that would be comparable if the transaction was occurring between unrelated parties.
- It ensures that the transaction between 'related' parties is at a price that would be comparable if the transaction was occurring between unrelated parties.
- Suppose company A purchases goods for 100 rupees and sells them to its associated company B in another country for 200 rupees, which in turn sells in the open market for 400 rupees.
- Had A sold it directly, it would have made a profit of 300 rupees.
- But by routing it through B, it restricted to 100 rupees, permitting B to appropriate the balance.
- The transaction between A and B is arranged and not governed by market forces.
- The profit of 200 rupees is, thereby, shifted to the country of B.
- The goods are transferred at a price (transfer price) that is arbitrary or dictated (200 hundred rupees) but not on the market price (400 rupees).
- Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction.
- For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries and low transfer prices to move profits to subsidiaries located in low tax jurisdictions.
- As an example of this, a group that manufactures products in high tax countries may decide to sell them at a low profit to its affiliate sales company based in a tax haven country.
- That company would, in turn, sell the product at an arm's length price, and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.

Section 92 of the Income Tax Act, 1961

This section discusses the computation of income from international transactions having regard to arm's length price.

This section states that any international or specified domestic transaction between associated enterprises which has been mutually agreed upon and undertaken for allocation or apportionment of any cost or expense incurred or

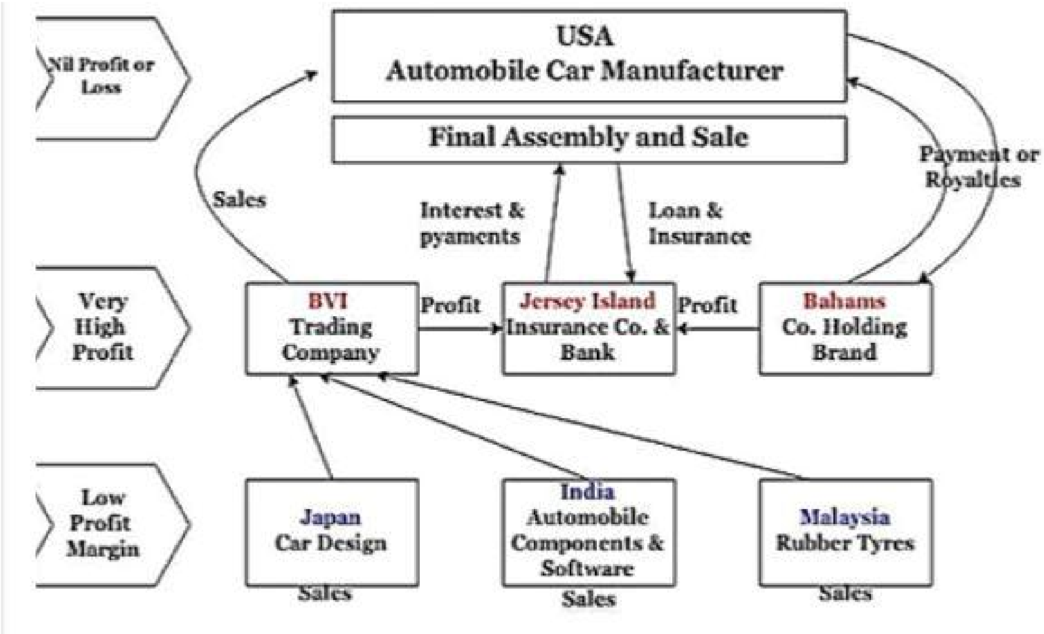
To be incurred for a benefit, service, or facility undertaken or to be undertaken by one or more of the enterprises, then the cost or expense allocated, must be contributed having regard to the arm's length price of such benefit, service, or facility.

Section 92E – Audit Under Transfer Pricing

A report from an accountant has to be furnished by persons who are entering into an international transaction or a specified domestic transaction.

A report from an accountant in a prescribed form, duly signed and verified by the accountant must be obtained before the specified date by any person entering into an international transaction or specified domestic transaction in the previous year.

The audit applies to both international and specified domestic transactions. Form 3CEB must be filed.



7.5 Transfer Pricing Methods

- Market Prices
- Cost-Based Prices
- Negotiated Prices
- Dual Prices

1. Market Prices method

- Market Price refers to a price in an intermediate market between Independent Buyers and Sellers.

Preconditions for Market Prices method

Under competitive external market for transferred goods, this method works well.

- When transferred goods are reported at market pricing, divisional performance is more likely to reflect the division's true economic contribution to overall company profitability.
- If the items are unable to be obtained from a division within the corporation, the intermediate product must be purchased from the outside market at the current market price. As a result, divisional profits are expected to be comparable to those computed if the divisions were independent organizations.
- As a result, divisional profitability can be directly compared to the profitability of similar enterprises operating in the same sort of company. Managers of both the buying and selling divisions are generally uncertain about trading with each other or with outsiders.
- No division can gain an advantage at the expense of another. Top management will not be tempted to interfere in a market price issue.
- Market pricing is founded on the concept of opportunity costs.
- The opportunity cost approach indicates that the market price is the correct transfer price.
- Because the selling division can sell whatever it produces at market prices, transferring internally at a lesser price would be detrimental to the division.
- Likewise, the buying division can always get the intermediate items at the prevailing market price, so it would be unlikely to pay extra for an internally transferred good.

- Because the lowest transfer price for the selling division is the market price and the maximum price for the purchasing division is also the market price, the only feasible transfer price is the market price.
- The market price might be used to settle disputes between purchasing and selling divisions. From the company's perspective, market pricing is ideal as long as the selling division is running at full capacity.
- The market pricing does not allow for any gains or losses in the efficiency of the selling division. It lowers administrative costs since the adoption of competitive market prices is devoid of any disagreement, debate, or bias.
- Furthermore, transfer prices depending on the market prices are consistent with the ideas of profit centers and investment centers in responsibility accounting.
- In addition to motivating division managers to focus on divisional profitability, market-based transfer pricing assists in demonstrating the contribution of each division to the overall company profit.

Challenges of Market Price Approach of Transfer Pricing

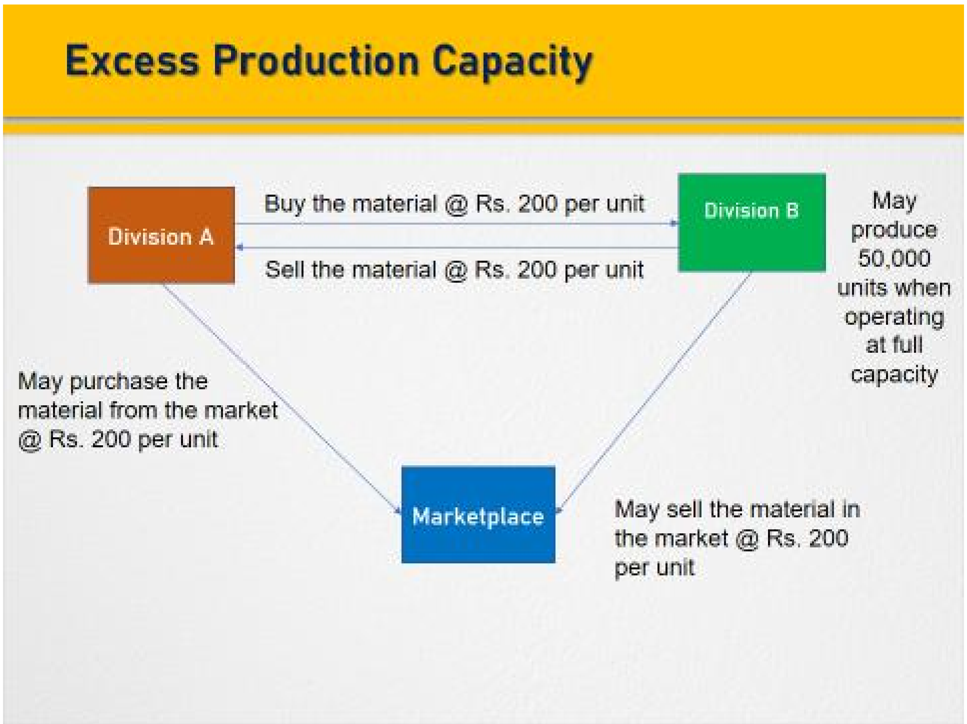
- Non-existence of appropriate market
- Excess Production Capacity
- Difficulty in measuring Opportunity Cost
- Nature of Transferred Goods
- Distress Market Prices

Non-existence of appropriate market

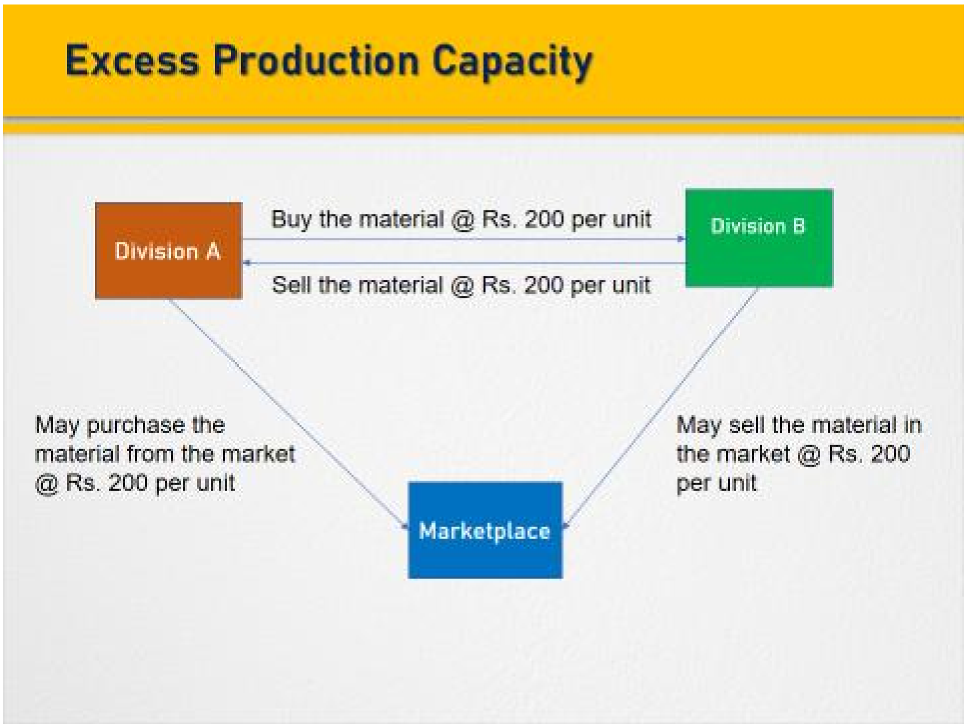
- Competitive markets do not actually exist.
- Catalogue price may only vaguely relate to actual sales prices.
- Market prices may change quite often.
- Internal selling expenses may be less in comparison to expenses incurred when goods are sold to outsiders.
- Also, when there are two responsibility centres in an organization, it indicates that there may be some advantages to being part of one company and not being two separate companies dealing with each other in the market.

Excess Production Capacity

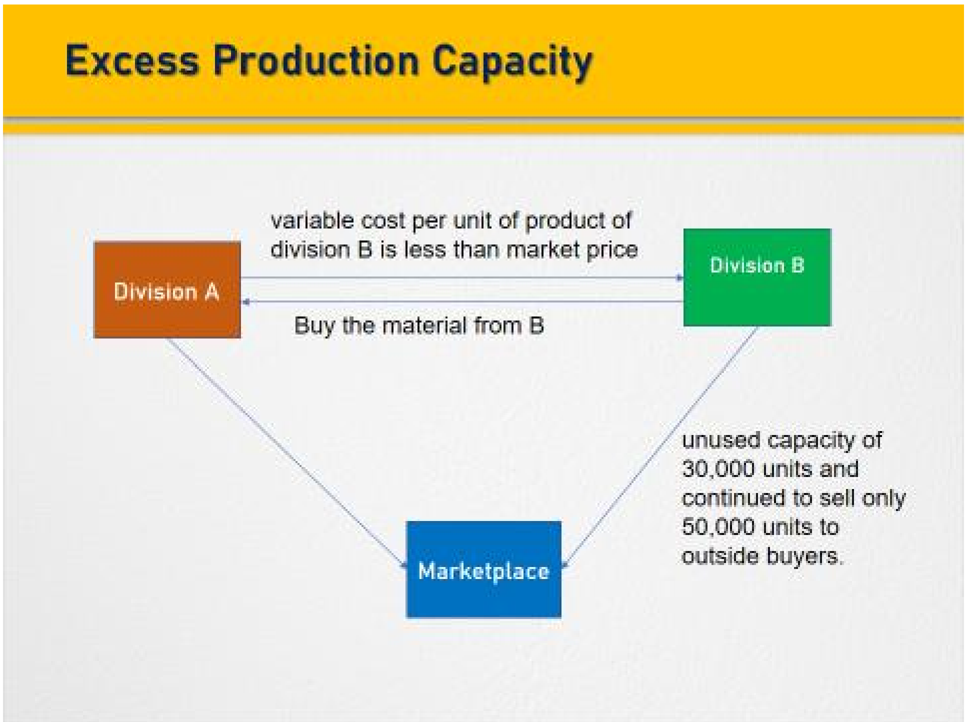
Another challenge with this method is when a selling division does not operate at full capacity and cannot sell all its products.



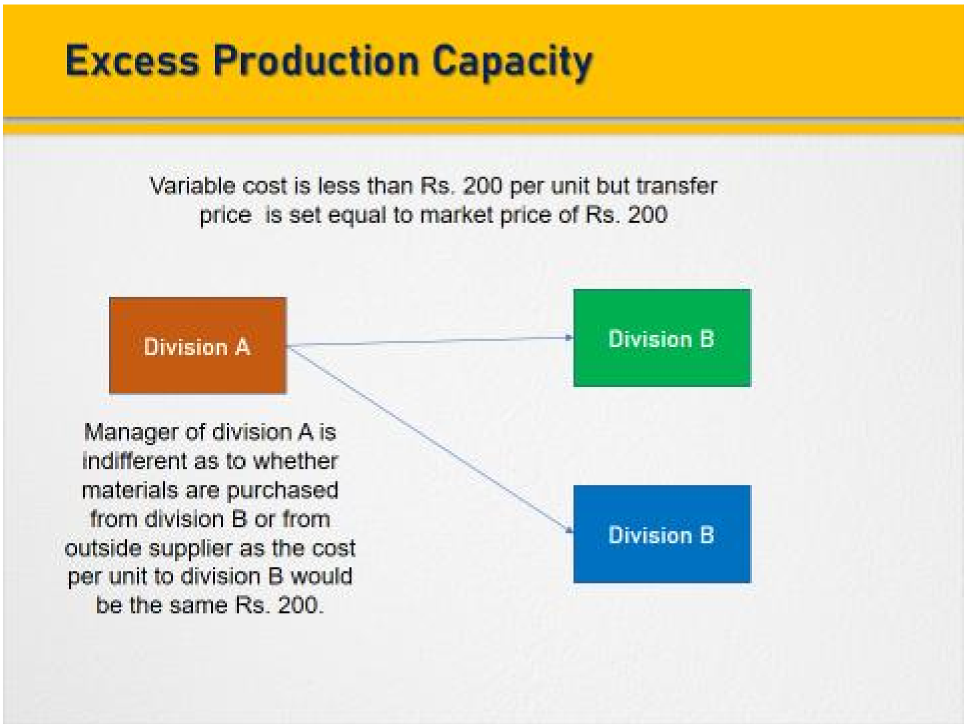
- Assume that material used by Division A is being purchased from outside at Rs. 200 per unit. This same material is also produced by division B.
- Let us say that it operates at full capacity and produces 50,000 units, which it can sell to division A or in the market.
- Whether the goods get sold to division A or outside buyers, using the transfer pricing has no effect on the income or profit of the company.
- Division B will earn Rs. 200 per unit irrespective of whether division A buys the material or it is sold in the market.
- Similarly, division A shall have to pay Rs. 200 per unit whether it chooses to buy within the company from division B or buy from the market.
- In this case, the use of market price as a transfer price is appropriate.
- If division B is not operating at full capacity and has unused capacity existing in the division, the use of market price may not lead to maximization of total profit of company.



- Assume that division B has an unused capacity of 30,000 units and continues to sell only 50,000 units to outside buyers.
- In this case, the transfer price should be set to motivate the manager of division A to purchase from division B if the variable cost per unit of the product of division B is less than the market price.



- If the variable cost is less than Rs. 200 per unit, but the transfer price is set equal to the market price of Rs. 200, then the manager of division A is indifferent as to whether materials are purchased from division B or from an outside supplier as the cost per unit to division B would be the same Rs. 200.



- If division A purchases 20,000 units of material from outside suppliers at the cost of Rs. 200 per unit, it would not maximize overall company profit since this market price per unit is greater than the unit variable cost of division B, say Rs. 100.
- Thus, Intra company transfer could save the company difference between market price per unit and division Bs' unit variable expenses. This saving of Rs. One hundred per unit would receive an ass Rs. 20,00,000 to the overall profit of the company.

Difficulty in measuring Opportunity Cost

External market may not be perfectly competitive.•Under perfect competition, market price does not depend on the quantity sold by any producer.

Under imperfect competition, a single producer or group of producers can affect market price depending on the production decisions of the producer.

It means the opportunity cost incurred by the company as a result of internal transfers depends on the quantity sold externally. Thus, opportunity cost cannot be appropriately assessed.

Another reason for the difficulty in measuring the opportunity cost is the uniqueness of transferred goods or services.

It requires the producing division to invest in special equipment to produce transferred goods or services.

For example, producing division may provide design services as well as production of goods for a buying division.

What is the opportunity cost related to each of these related outputs of producing division? In such a case, it is challenging to sort out the opportunity costs.

Distress Market Prices

- When supply outstrips demand, market prices may drop well below their historical average.
- If the drop in prices is expected to be temporary, these low market prices are sometimes called distress prices.
- Occasionally, an industry will experience a period of significant excess capacity and extremely low prices.

Distress Market Prices example

- When petrol prices soared due to a foreign oil embargo, the market prices for recreational vehicles and power boats fell temporarily to very low levels.
- Under such extreme conditions, basing transfer prices on market prices can lead to decisions that are not in the best interests of the overall company.
- Basing transfer pricing on artificially low distress market prices could lead the producing division to sell or close productive resources devoted to producing the product for transfer.
- Under distress market prices, producing division managers might improve divisions' profit in the short run, but it could be contrary to the best interests of the company overall.
- It might be better for the company as a whole to avoid divesting itself of any productive resources and to ride out the period of market distress.
- To encourage an autonomous division manager to act in this fashion, some companies set the transfer price equal to the long-run average external market price rather than the current market price..

2. Cost Based Prices

This method is used when there is the non-existence of external markets or when information about market prices is not readily available.

a) Variable Cost

b) Actual Full Cost

c) Full cost Plus Profit Margin

d) Standard Full Cost

Variable Cost Method

- Useful when a business operates below capacity•
- Manager of a selling division will generally not like it as no profit gets yielded to it.
- In this system of pricing, only variable cost, namely: direct material, direct labor, and variable factory overheads, gets transferred.
- The variable cost has the major advantage of encouraging maximum profits for the entire firm.
- By passing only variable overheads to the next division, production and pricing divisions are based on the Cost-Volume-Profit relationship for the firm as a whole
- The obvious challenge is that the selling division is left holding all its fixed costs and operating expenses.
- It is important to note that the division is a loss-making division, which is nowhere near a profit centre.

Actual Full Cost Method

- Transfer price is based on total product cost per unit, which includes direct labor, direct material, and factory overheads.
- When full cost is used for transfer pricing, the selling division cannot realize a profit on goods transferred.
- This may be a disincentive to the selling division. Further, full-cost transfer pricing can provide perverse incentives and distort performance measures.

Full cost Plus Profit Margin Method

- It overcomes the weaknesses of the full cost basis of the transfer pricing system.

- Full cost plus price includes the allowed cost of the item plus a markup or other profit allowance.

Standard Cost Method

- In actual approaches, there is a problem of measuring cost through actual cost method.
- While transferring actual costs, any variances or inefficiencies in the selling division are passed on to buying division.
- The problem of isolating the variance that has been transferred becomes extremely complex.
- To promote responsibility in selling division and to isolate variances within divisions, standard costing are usually used as a basis for transfer pricing in cost-based systems.

Negotiated Prices

- Negotiated transfer pricing refers to when a firm's representatives negotiate prices on their own, rather than relying solely on market prices.
- Negotiating a transfer price between subsidiaries without referring to any market pricing as a starting point may be required.
- Negotiated pricing is widely recommended as a compromise between market and cost-based pricing.
- Negotiation methods are likely similar to those used when dealing with external markets.
- The managers who negotiate prices behave similarly to those of independent businesses.

Dual Pricing

Two separate transfer pricing methods adopted to price each interdivisional transaction.

Selling division sells goods at:

1. Market or Negotiated price
2. Cost Plus Margin

But, the buying division transfer is based on a cost-based amount (preferable variable costs of the selling division).

The difference in transfer pricing for the two divisions could account for by a particular centralized account.

7.6 International Transfer Pricing

- Creation of foreign subsidiaries and bases of operation for cross-border flow of products, services, trademarks, funding and technology has a significant impact on the issue of transfer pricing in today's business scenario.
- Transfer pricing problem for multinationals is of great significance. There are different income tax rates in different countries. So, it becomes desirable from the view-point of overall corporate strategy to show higher profits in low-tax countries and lower profits in high-tax countries.

Issues of International Transfer Pricing

- Income Tax Rates
- Import Duties

- Income Tax Rates – Multinational companies always consider domestic and foreign income tax rates while setting transfer prices.
- Assume that an Indian company has a division in Canada. India's division manufactures a component transferred to the Canadian division for assembly and sale of the final product. Different income tax rates will influence the transfer price for the component. Suppose the income tax rate in India is higher than that in Canada.
- Suppose the management of the company sets a lower transfer price for the component; this will result in lower profits for the Indian division because transfer prices become revenue for this Indian division. However, the lower transfer prices will produce high income for the Canadian division; the overall company will save on income tax.
- The company, by setting a low transfer price, tends to shift a portion of its income to a country having a lower tax rate. Some countries have regulations and laws prohibiting such transfer pricing practices.
- 2. Import Duties: Transfer pricing policies followed by multinational companies are affected by import duties or tariffs. These are the fees charged to an importer generally based on the reported value of goods being imported.
- Let us recall the example we discussed if Canada imposes import duty on goods transferred in from the Indian division; the company is incentivised to set a relatively low transfer price on transferred goods.
- This will reduce the duty to be paid and maximize overall profit for the company. Like income tax, countries sometimes make laws to restrict multinational firms' flexibility in setting transfer prices to minimize import duties payable by them.

Factors Affecting Multinational Transfer Pricing

- Tool to minimize worldwide taxes, duties and tariffs
- Avoidance of financial restrictions on profit repatriation imposed by Government
- Avoidance of divisional conflict
- Overall goal congruence
- Inflation

Benefits of International Transfer Pricing

- Transfer pricing helps reduce duty costs by shipping goods into countries with high tariff rates by using low transfer prices to lower the duty base of such transactions.
- Reducing income and corporate taxes in high-tax countries by overpricing goods that are transferred to countries with lower tax rates helps companies obtain higher profit margins.

Drawbacks of International Transfer Pricing

1. There can be disagreements within the divisions of an organization regarding the policies on pricing and transfer.
2. Many additional costs are incurred in terms of time and manpower required to execute transfer prices and maintain a proper accounting system to support them. Transfer pricing is a very complicated and time-consuming methodology.
3. It is challenging to establish prices for intangible items such as services that are not sold externally. Sellers and buyers perform different functions and, thus, assume different types of risks.
4. For instance, the seller may refuse to provide a warranty for the product. But the price paid by the buyer would be affected by the difference.

Summary

Multinational corporations (MNCs) have certain leeway in determining how to distribute revenues and expenses to subsidiaries situated in various countries for the purposes of management accounting and reporting. A subsidiary of a firm may be separated into segments or accounted for as a separate entity. In these circumstances, transfer pricing assists in properly allocating revenue and expenses to such subsidiaries. The profitability of a subsidiary is determined by the pricing at which inter-company transactions take place. Governments are increasingly scrutinising inter-company transactions these days. When transfer pricing is used, it can have an impact on shareholder wealth since it affects the company's taxable income and after-tax free cash flow. It is critical for a firm that conducts cross-border intercompany transactions to comprehend the transfer pricing concept, particularly in order to meet legal obligations and avoid the risk of noncompliance.

So, that was all about the meaning, objectives, importance and limitations, domestic, and international transfer pricing.

Keywords

Section 80A (6) transactions: Section 80A (6) applies to internal transactions in goods or services between the assessee's numerous units / undertakings. This phrase applies to any transaction involving products or services, and hence this transaction will be applicable to both income and expenditure.

Arms Length Price: The price at which a willing buyer and a willing unrelated seller would freely agree to transact, or a trade between related parties done as if they were unrelated, so that the transaction does not include a conflict of interest.

Controlled transaction:This is a transaction that occurs between two related company entities, such as a company's French and German divisions, and for which arm's length transfer price must be determined.

Self Assessment

1. The goal of transfer pricing is to arrive at an arm's length price for commodities sold or services supplied by -

A. From one enterprise segment to another within the same enterprise.

B. From one enterprise to the next

C. Both A and B are correct.

D. Neither A nor B are true.

2. If one of an enterprise's segments claims a tax holiday, the purpose of transfer pricing is to ensure that the profit of that segment is not -

A. Overstated

B. Understated

C. A or B

D. Neither A nor B are true.

3. Transfer pricing provisions apply to which of the following transactions?

A. MNE group’s two group companies

B. A foreign company and its Indian branch

C. An Indian company and its subsidiary benefiting from a tax holiday

D. All of the above

4. The transfer price is the price payable between -

A. Two or more MNE entities [Associated Enterprises (AE' s)] operating in the same country.

B. Two or more MNE entities [Associated Enterprises (AE' s)] that operate in various nations.

C. Both A and B are correct.

D. Neither A nor B are true.

5. X Ltd. operates in Country A, where the corporate tax rate is 30%. It plans to offer goods worth $100 to a buyer in Country B for $150. To save taxes, X Ltd. formed a subsidiary in Country Y, Subsidiary C, where the tax rate is 10%, and sold the goods to C for USD 125, who then sold the items to a buyer in Country B for USD 150.

In this situation, the tax will be:

A. USD15

B. USD10

C. USD5

D. None of the above

6. Transfer pricing is the process of determining the price of products and services that are traded between parties.

A. Controlled legal entities within a business

B. Independent legal entities within a business

C. Both A and B

D. Neither A nor B are true

7. Tax planning opportunities exist as a result of differences in........... between various countries.

A. Tax rates

B. Tax breaks

C. A and B both

D. Neither A nor B are true.

8. Transactions between unrelated entities occur at -

A. Price at Arm's Length

B. Price Control

C. One of A or B

D. Both A and B are correct.

9. Transfer pricing's goal is to ensure which of the following -

A. Taxes are paid in the country of residence.

B. Taxes are paid in the country of origin.

C. No taxes are collected

D. Taxes are collected in the jurisdiction where economic activity occurs

10. Transfer pricing research seeks to arrive at an arm's length price under the assumption that the transaction's participants are...........

A. Unrelated

B. Related

C. Controlled

D. Both B and C

11. Which of the following statements about transfer pricing is correct?
A. Income from international transactions must be calculated using the arm's length pricing.
B. Any expense/allowance for interest in computing income for foreign transactions shall also be computed on the basis of the expense/length interest's arm's price.
C. Under a mutual agreement or arrangement, the cost or costs assigned or apportioned between Associated firms shall be at arm's length pricing.
D. All of the preceding

12. The transfer pricing provisions are meant to ensure that
A. profits are not underestimated,
B. expenses are not understated,
C. losses are not overstated, and
D. both A and C are not violated.

13. The primary goal of transfer pricing regulations is to prevent
A. profit shifting by increasing prices charged by overseas entities or paid by Indian entities in international transactions;
B. profit shifting by decreasing prices charged by overseas entities;
C. profit shifting by decreasing prices paid by Indian entities; and
D. none of the above.

14. Transfer pricing provisions should not be used where using the arm's length price would result in a -
A. Reducing the amount of tax payable in India
B. Increasing the tax due in India
C. Increasing the Indian company's expenditure
D. Both A and C

15. ABC Ltd. purchased goods from its AE in the United States for USD 200 per unit. However, it was acquiring the identical material from an independent third party in the United States for USD 250 per unit. The Arm's Length Price in this scenario would be:
A. Rs. 200;
B. Rs. 250;
C. A or B
D. Neither A nor B are true.

Answers for Self Assessment

l.	A	2.	A	3.	D	4.	B	5.	B
6.	A	7.	C	8.	A	9.	D	10.	A
11.	D	12.	D	13.	A	14.	D	15.	A

Review Questions

1) What are the most pressing challenges in transfer pricing?
2) What are the different methods ways of transfer pricing?
3) How can you determine whether transfer pricing is applicable?
4) What enterprises are called associated enterprises?
5) What happens if we enter the wrong transfer pricing?

Further Readings

A text book on International Accounting and Reporting Issues: 2018 Review by United Nations Conference on Trade and Development (UNCTAD) · 2019

A text book on Dual Reporting for Equity and Other Comprehensive Income by Francesco Bellandi

Web Links

- https://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx
- https://cleartax.in/g/terms/transfer-pricing
- https://taxguru.in/income-tax/basics-transfer-pricing-india.html
- https://taxguru.in/income-tax/domestic-transfer-pricing.html

Unit 08:Segment Reporting

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the meaning, objectives, importance and limitations of segment reporting.
- discuss the International GAAP on segment reporting.
- discuss the Indian GAAP on segment reporting.

Introduction

Large organizations divide their business into different units, where these units are created based on their product or geographical location. These units are termed as segments of the organization. At the end of the year, all units so created are to be merged with that of the organization, but certain units, as per the criteria mentioned, have to be reported separately. Have you ever wondered how the organizations divide their business into different units? Segment reporting can be defined as the disaggregation of a company's financial statements or a group of companies into different segments covering sales, revenues and profits, line of business, and geographical markets. Large companies with diversified product lines/marketing regions, which may differ in profitability, growth potential, and risk, evidently require segment reporting to highlight different areas. Segment reporting requires companies, especially those which are multi-product and multi-location to disclose their segment-wise operations in their annual reports as well as in their quarterly reports. The users of financial statements have different utilities for financial information. The users of accounting information are the stakeholders, mainly concerned with financial information of various business segments. Furthermore, companies may be required to update their accounts on a regular basis to keep them current with economic and financial situations, augmenting cost-based financial statements with frequent price-level adjusted statements.

8.1 Meaning of Segment Reporting

- It is the reporting of the operating segments of a company in the disclosures accompanying its financial statements.
- It is required for publicly-held entities and not for privately held ones.
- Segment reporting is intended to give information to investors and creditors regarding the financial results and position of the most important operating units of a company, which they can use as the basis for decisions related to the company.
- Under Generally Accepted Accounting Principles (GAAP), an operating segment engages in business activities from which it may earn revenue and incur expenses, has discrete financial information available, and whose results are regularly reviewed by the entity's chief operating decision maker for performance assessment and resource allocation decisions.

8.2 Objectives of Segment Reporting

1. For a better understanding of the performance and evaluation of the organization's results.
2. To provide information to the stakeholders about the important units of the organization to evaluate and make decisions about the investment.
3. To make the accounts more transparent and understandable.
4. To make better decisions by taking in mind the business from different segments.
5. For a better analysis of the risk and returns of the organization.

To analyze the most profitable or Loss-making units.

8.3 Significance of Segment Reporting

- Segmental reporting is important for the organization, its investors, and the stakeholders in various ways.
- It provides investors the complete details about the units, their profitability, etc. They can analyze and decide upon the investment in the organization.
- It helps the organization in better decision- making as the planning about expansion or diversification is to be done based on the result of the segment.
- It helps the creditors decide the credit terms based upon the analysis of each segment separately.
- It helps the shareholders decide whether to retain the shares or sell them.
- It helps management decide whether to expand the segment or sell off the segment.
- Segmental Reporting gives a better understanding of financial statements. The profit-making and loss-making units can be easily identified with the help of segmental reporting.
- It helps in the optimum utilization of resources and better presentation. It helps potential investors in better investment decisions.

Case Analysis**:** PKF Ltd has eight units-based product-wise. Each unit deals with different products. The Revenue, Profits, and the Assets of each unit are shown as under –

(Amount in $ in Million)

Particulars	Unit A	Unit B	Unit C	Unit D	Unit E	Unit F	Unit G	Unit H	Total
Assets	50	70	40	60	89	78	52	46	485
Revenue	650	870	350	800	950	750	990	590	5950
Profit	7	7.5	3.5	4	9	5	3.2	2.8	42

Decide which all units are to be reported as per segmental reporting?

Solution

A Unit is to be reported as per segment reporting if:

a) Assets of the unit are greater than or equal to 10 percent of the organization's total assets.

b) Profit or loss is more than or equal to 10 percent of the organization's total profit or loss.

c) Revenue is more than or equal to 10 percent of the organization's total income.•

Particulars	Unit A	Unit B	Unit C	Unit D	Unit E	Unit F	Unit G	Unit H	Total
Assets	50	70	40	60	89	78	52	46	485
Revenue	650	870	350	800	950	750	990	590	5950
Profit	7	7.5	3.5	4	9	5	3.2	2.8	42
Percentage of Assets to Total assets	10.31%	14.43%	8.25%	12.37%	18.35%	16.08%	10.72%	9.48%	
	(50/485*100)	(70/485*100)	(40/485*100)	(60/485*100)	(89/485*100)	(78/485*100)	(52/485*100)	(46/485*100)	
Percentage of Revenue to Total assets	10.92%	14.62%	5.88%	13.45%	15.97%	12.61%	16.64%	9.92%	
	(650/5950*100)	(870/5950*100)	(350/5950*100	(800/5950*100)	(950/5950*100)	(750/5950*100)	(990/5950*100)	(590/5950*100)	
Percentage of Profit to Total Profit	16.67%	17.86%	8.33%	9.52%	21.43%	11.90%	7.62%	6.67%	
	(7/42*100)	(7.5/42*100)	(3.5/42*100)	(4/42*100)	(9/42*100)	(5/42*100)	(3.2/42*100)	(2.8/42*100)	

8.4 Limitations of Segment Reporting

- Many disclosures are required in the case of segmental reporting; hence, it is time-consuming.
- The data presented can be misinterpreted by the investors or creditors.
- Method of reporting Inter-segment transactions are different for each organization.
- The base of the segment is also different as some organizations divide the segment based on geographical location, and some organizations divide it based on product-wise.
- The common costs are sometimes difficult to allocate.

Criteria for Segment Reporting

Revenue of segment is to be greater than or equal to 10 percent of the revenue of the organization as a whole; or Profit of the segment is to be greater than or equal to 10 percent of the profit of the organization; or The segment's assets are to be greater than or equal to 10 percent of the organization's total assets. Any segment that meets any of the criteria discussed. In that case, that segment is to be reported separately. All income, expenses, assets, and liabilities of that segment need to be shown separately per the law requirements.

Overview of International Segment Reporting

- Primary format based on whether the entity's risks and returns are affected predominantly by the products and services it produces or by the fact that it operates in different geographical areas.
- IAS 14 was issued in August 1997, was applicable to annual periods beginning on or after 1 July 1998 and was superseded by IFRS 8 *Operating Segments with effect from annual periods beginning on or after 1 January 2009.*

International Accounting Standard (IAS-14) - Scope of Reporting the Financial Information by Segment

- IAS-14 is applied in reporting financial information by segments of an enterprise-specifically, the different industries and geographical areas in which it operates.
- This International Accounting Standard (IAS-14) becomes operative for financial statements covering periods beginning on or after 1-1-1983 except that, in the interests of uniform application
- This International Accounting Standard (IAS-14) becomes operative for financial statements covering periods beginning on or after 1-1-1983 except that, in the interests of uniform application in a particular country, for subsidiaries whose Standard become, in all material respect, accepted practice for economically significant domestic entities in that country.
- securities are not publicly traded; IAS-14 becomes operative when the requirements expressed in this
- Enterprises whose securities are publicly traded and other economically significant entities, including subsidiaries, should report the financial information as per IAS- 14 for the industry Segments and for the geographical segments which are considered to be significant to the enterprise.
- When both parent company and consolidated financial statements are presented, segment information must be presented only based on consolidated financial statements.

Objectives of IAS 14

- The objective of IAS 14 (Revised 1997) is to establish principles for reporting financial information by line of business and geographical area.
- It applies to entities whose equity or debt securities are publicly traded and to entities in the process of issuing securities to the public.
- In addition, any entity voluntarily providing segment information should comply with the requirements of the Standard.

Applicability of IAS 14

- IAS 14 must be applied by entities whose debt or equity securities are publicly traded and those in the process of issuing such securities in public securities markets. [IAS 14.3]
- If an entity that is not publicly traded chooses to report segment information and claims that its financial statements conform to IFRSs, it must follow IAS 14 in full. [IAS 14.5]
- Segment information need not be presented in the separate financial statements of a (a) parent, (b) subsidiary, (c) equity method associate, or
- (d) equity method joint venture that are presented in the same report as the consolidated statements. [IAS 14.6-7]

Definitions Under IAS 14

1. Business segment: a component of an entity that (a) provides a single product or service or a group of related products and services and (b) that is subject to risks and returns that are different from those of other business segments. [IAS 14.9]
2. Geographical segment: a component of an entity that (a) provides products and services within a particular economic environment and
3. (b) that is subject to risks and returns that are different from those of components operating in other economic environments. [IAS 14.9]
4. Reportable segment: a business segment or geographical segment for which IAS 14 requires segment information to be reported. [IAS 14.9]
5. Segment revenue: revenue, including intersegment revenue, that is directly attributable or reasonably allocable to a segment.
6. Includes interest and dividend income and related securities gain only if the segment is a financial segment (bank, insurance company, etc.). [IAS 14.16]
7. Segment expenses: expenses, including expenses relating to intersegment transactions, that (a) result from operating activities and (b) are directly attributable or reasonably allocable to a segment.
8. Includes interest expense and related securities losses only if the segment is a financial segment (bank, insurance company, etc.).
9. Note: Segment expenses do not include interest, losses on sales of investments or debt extinguishments losses on investments accounted for by the equity method; income taxes
10. general corporate administrative and head-office expenses that relate to the entity as a whole [IAS 14.16]
11. Segment result: segment revenue minus segment expenses, before deducting minority interest. [IAS 14.16]
12. Segment assets and segment liabilities: those operating assets (liabilities) that are directly attributable or reasonably allocable to a segment. [IAS 14.16]

Identifying Business and Geographical Segments

- An entity must look to its organizational structure and internal reporting system to identify reportable segments.
- In particular, IAS 14 presumes that segmentation in internal financial reports prepared for the board of directors and chief executive officer should……..
- normally determine segments for external financial reporting purposes.
- If internal segments are not along either product/service or geographical lines, further disaggregation is appropriate.[IAS 14.26]
- Geographical segments may be based either on where the entity's assets are located or where its customers are. [IAS 14.14]
- Whichever basis is used, several data items must be presented on the other basis if significantly different. [IAS 14.71-72]

Primary and Secondary Segments

- For most entities, one basis of segmentation is primary, and the other is secondary, with considerably less disclosure required for secondary segments.
- The entity should determine whether business or geographical segments are to be used for its primary segment reporting format based on whether the entity's risks and returns are affected predominantly by the products and services it produces or by the fact that it operates in different geographical areas.
- The basis for identification of the predominant source and nature of risks and differing rates of return facing the entity will usually be the entity's internal organizational and

management structure and its system of internal financial reporting to senior management. [IAS 14.26-27] and its system of internal financial reporting to senior management. [IAS 14.26-27]

Which Segments are Reportable?

- The entity's reportable segments are its business and geographical segments, for which a majority of its revenue is earned from sales to external customers and for which: [IAS 14.35]
- revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal, of all segments; or segment result, whether profit or loss, is 10% or more the combined result of all segments in profit or the combined result of all segments in loss,
- whichever is greater in absolute amount; or assets are 10% or more of the total assets of all segments.
- Segments deemed too small for separate reporting may be combined, if related, but they may not be combined with other significant.
- segments for which information is reported internally. Alternatively, they may be separately reported.
- They must be included as an unallocated reconciling item if neither combined nor separately reported.[IAS 14.36]
- If total external revenue attributable to reportable segments identified using the 10% thresholds outlined above is less than 75% of the total
- consolidated or entity revenue, additional segments should be identified as reportable segments until at least 75% of total consolidated or entity revenue is included in reportable segments. [IAS 14.37]
- Vertically integrated segments (those that earn a majority of their revenue from intersegment transactions) may be, but need not be reportable segments.
- [IAS 14.39] If not separately reported, the selling segment is combined with the buying segment. [IAS 14.41]
- IAS 14.42-43 contain special rules for identifying reportable segments in the years in which a segment reaches or loses 10% significance.

8.5 What Accounting Policies Should a Segment Follow?

- Segment accounting policies must be the same as those used in the consolidated financial statements. [IAS 14.44]
- If assets used jointly by two or more segments are allocated to segments, the related revenue and expenses must also be allocated. [IAS 14.47]

What Must be Recorded?

- IAS 14 has detailed guidance as to which items of revenue and expense are included in segment revenue and segment expense.
- All companies will report a standardized segment results measure– operating profit before interest, taxes, and head office expenses.
- For an entity's primary segments revised IAS 14 requires disclosure of: [IAS 14.51-67]; sales revenue (distinguishing between external and intersegment)
  - result
  - assets
  - the basis of intersegment pricing
  - liabilities

- capital additions
- depreciation and amortization
- significant unusual items
- non-cash expenses other than depreciation
- equity method income
- Segment revenue includes "sales" from one segment to another.
- Under IAS 14, these intersegment transfers must be measured on the basis that the entity actually used to price the transfers. [IAS 14.75]
- For secondary segments, disclose: [IAS 14.69-72]
    - revenue
    - assets
    - capital additions

Other Disclosure Matters Addressed in IAS 14

- Disclosure is required of external revenue for a segment that is not deemed a reportable segment because most of its sales are intersegment sales, but nonetheless, its external sales are 10% or more of consolidated revenue.[IAS 14.74]
- Special disclosures are required for changes in segment accounting policies. [IAS 14.76]
- Where there has been a change in the identification of segments, prior year information should be restated. If this is not practicable, segment data should be reported for both the old and new segmentation bases in the year of change. [IAS 14.76]
- Disclosure is required of the types of products and services included in each reported business segment and the composition of each reported geographical segment, both primary and secondary. [IAS 14.81]
- An entity must present a reconciliation between information reported for segments and consolidated information.
- At a minimum: [IAS 14.67] segment revenue should be reconciled to consolidated revenue
- segment result should be reconciled to a comparable measure of consolidated operating profit or loss and consolidated net profit or loss
- segment assets should be reconciled to entity assets
- segment liabilities should be reconciled to entity liabilities.

8.6 Accounting Standard (AS) 17

- This Accounting Standard is not obligatory for Small and Medium Sized Companies, as per the Notification.
- However, they are encouraged to comply with the Standard to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates.
    - Such information helps users of financial statements:
    - better understand the performance of the enterprise;
    - better assess the risks and returns of the enterprise; and
    - make more informed judgements about the enterprise as a whole.
    - Many enterprises provide groups of products and services or operate in

- geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks.
- Information about different types of products and services of an enterprise and its operations in different geographical areas - often called segment information, which is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data.
- Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

Scope of Accounting Standard (AS) 17

1. This Standard should be applied in presenting general purpose financial statements.
2. The requirements of this Standard are also applicable in case of consolidated financial statements.
3. An enterprise should comply with the requirements of this Standard fully and not selectively.
4. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segmentinformation need be presented only on the basis of
5. the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Standard to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.
6. statement items should construed to be the relevant item as appearing in the consolidated financial statements.

Disclosure Practices

Paragraph 38 discusses that from Paragraphs 39-46 specify the disclosures required for reportable segments for primary segment reporting format of an enterprise.

Paragraphs 47-51 identify the disclosures required for secondary reporting format of an enterprise.

Enterprises are encouraged to make all of the primary-segment disclosures identified in paragraphs 39-46 for each reportable secondarysegment although paragraphs 47-51 require considerably less disclosure on the secondary basis. Paragraphs 53-59 address several other segment disclosure matters.

The disclosure requirements in paragraphs 40-46 should be applied to each reportable segment based on primary reporting format of an enterprise.

An enterprise should disclose the following for each reportable segment: (a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

- segment result;
- total carrying amount of segment assets;
- total amount of segment liabilities;
- total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
- total amount of expense included in the segment result for depreciation and amortization in respect of segment assets for the period; and
- total amount of significant non-cash expenses, other than depreciation and amortization in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.
- Paragraph 40 (b) requires an enterprise to report segment result. If an enterprise can compute segment net profit or loss or some other measure of segment profitability other than segment result,

- without arbitrary allocations, reporting of such amount(s) in addition to segment result is encouraged.
- If that measure is prepared on a basis other than the accounting policies adopted for the financial statements of the enterprise, the enterprise will include in its financial statements a clear description of the basis of measurement.
- An example of a measure of segment performance above segment result in the statement of profit and loss is gross margin on sales.
- An enterprise is encouraged, but not required, to disclose the nature and amount of any
- items of segment revenue and segment expense that are of such size, nature, or incidence that their
- disclosure is relevant to explain the performance ofthe segment for the period.
- Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items.
- The disclosure, however, does change the level at which the significance of such items isevaluated for disclosure purposes from the enterprise level to the segment level.
- An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortization expense and non-cash expenses of such segment pursuant to sub-paragraphs (f) and (g) of paragraph 40.
- Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows.
- Disclosure of segment cash flow is, therefore,encouraged, though not required. An enterprise that provides segment cash flow disclosures need not
- disclose depreciation and amortisation expenseand non-cash expenses pursuant to sub-paragraphs (f) and (g) of paragraph 40.
- An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements.

8.7 Inflation Accounting

Inflation accounting is a novel way for weighing the effects of rising or falling product prices in various parts of the world on the declared statistics of multinational corporations. Rather than relying exclusively on cost accounting, financial statements are modified in accordance with price indexes to provide a clearer picture of a firm's financial status in inflationary environments. This method is also known as price level accounting.

When a company works in a country with high market inflation or deflation, historical information on financial accounts is no longer useful. Companies are permitted in some situations to utilise inflation-adjusted figures to address this issue, restating the figures to represent current economic realities.

International Financial Reporting Standards (IFRS) IAS 29 directs organisations whose functioning currency is the currency of a hyperinflationary economy. The International Financial Reporting Standards (IFRS) define hyperinflation as rates, debt, and wages related to a price index that rises by 100% or more over three years.

Companies in this category may need to update their accounts on a frequent basis to keep them relevant to current economic and financial situations, augmenting cost-based financial statements with regular price-level adjusted statements.

Methods for Price level Accounting

Inflation accounting employs two basic approaches: current purchasing power parity (CPP) and current cost accounting (CCA).

Current Purchasing Power (CPP):

The CPP technique distinguishes between monetary and non-monetary commodities. The accounting adjustment for monetary items is subject to recording a net gain or loss. Non-monetary facts are converted into figures using a conversion factor equal to the end-of-period price index divided by the date of transaction.

Current Cost Accounting (CCA): The CCA approach evaluates assets at their fair market value (FMV) rather than the amount paid when the fixed asset was purchased. Currency and non-monetary goods are restated to current values under the CCA.

Benefits and Drawbacks

Accounting for inflation has numerous advantages. The most practical analysis of productivity is provided by comparing existing sales to current costs.

On the other hand, it can confuse investors by presenting altered figures and allowing corporations to mark numbers that help them look better. The process of updating accounts to reflect market movements will result in continual restatements and modifications to financial statements.

8.8 IAS 29

The only accounting standard dealing with inflation is IAS 29, *Financial Reporting in Hyperinflationary Economies*.

In IAS 29, the International Accounting Standards Board (IASB) does not define what makes a hyperinflationary economy, but it does provide a list of criteria that may indicate hyperinflation.

One of these factors is that the three-year cumulative inflation rate is approaching or exceeds 100%. A suggestion to reduce this proportion was explored in 2015, but the IASB chose not to proceed. Because of this relatively high index, most economies will not be classified as hyperinflationary.

According to an EY study dated April 2022, entities whose functional currency is that of any of the following ten nations should use IAS 29: Argentina, Iran, Lebanon, South Sudan, Sudan, Suriname, Turkey, Venezuela, Yemen, and Zimbabwe. According to the research, four other countries - Angola, Ethiopia, Haiti, and Syria - are not hyperinflationary but should be watched.

If IAS 29 is used, the financial statements must be restated using a general price index. This is frequently done to assets by multiplying the original cost by a factor.

For example, if an item of equipment was purchased for C10,000 when the price index was 400 and the price index is 1,000 at the reporting period, the restated value (before depreciation) is C10,000 x 1,000/400 = C25,000.

These changes apply only to non-monetary items, with monetary items provided at the reporting date's measuring unit. Gains and losses are reported in net income and must be disclosed individually. If a non-monetary item's restated amount exceeds its recoverable amount, it is lowered in accordance with the rules for item impairment.

Non-hyperinflationary economies

There will be no explicit accounting modifications for most organisations because no standard covers this. Increases in inflation rates, on the other hand, could have a major impact on employers that operate a defined benefit pension scheme. Closed systems may have the unintended consequence of minimising pension liabilities. As inflation rises, so will interest rates, which means that the discount rate used by businesses to record liabilities will rise, lowering the present value of payments.

The projected increase in salary expenses (and thus pension contributions) will have no effect on closed defined benefit systems, allowing pension liabilities to potentially shrink. Contribution increases may have a negative impact on schemes that remain open. This could be especially true for some public-sector pension plans, which already utilise greater discount rates than private-sector firms.

Increased discount rates may also result in a decrease in lease assets and liabilities, lowering the present value of payments made under existing agreements. If inflation continues to rise, businesses may be forced to renegotiate leasing agreements. If the lease terms change as a result, companies must consider how they should be applied in accordance with IFRS 16, Leases. If the adjustments involve decreases in right-of-use assets and lease liabilities, the terminations and any gain/loss should be estimated and documented.

"Inflation's impact on financial accounts is likely to be extensive."

Companies may choose to utilise the revaluation model in line with IAS 16 for their property, plant, and equipment if they consider the historic-cost model yields erroneous asset valuations. Companies must remember to revalue all assets within a certain class in this instance (ie all land and buildings). This revaluation may result in greater asset valuations, but it will also result in additional depreciation on the profit and loss statement. Entities can choose to transfer reserves to convert the excess depreciation from the revaluation surplus into retained earnings. Because this reserve transfer is only in equity, profits will remain lower.

Entities facing greater input costs are likely to boost their pricing to consumers. This may initially result in increased gross profits for organisations using first-in-first-out inventory value, but this is likely to be offset by increases in utility and payroll expenses.

Ifrs-Reporting-in-Hyperinflationary-Economy-ias-29

The results should be reported in terms of measuring unit current at the end of the reporting period.

It means that your financial accounts must be restated to reflect hyperinflation.

The three basic steps are as follows:

1. Determine the general price index (GPI);

   It literally means that various types of commodities and services indicative of that economy are included in. You may usually obtain it through local agencies such as national or central banks, statistical offices, or even the IMF (International Monetary Fund), which gives important information regarding CPI in a variety of countries.

   However, it is possible that a credible CPI or GPI is just unavailable.

   In this situation, the index can be calculated by comparing the fluctuation of the exchange rate between a stable currency (e.g., EUR...) and the hyperinflationary currency.

2. Restate the financial accounts at the end of the current reporting period using that GPI; and

2.1. Decision on monetary vs. non-monetary items

   After deciding on your GPI, the first step is to determine which assets and liabilities are monetary and which are not.

   Leave out equity elements for the time being; we'll deal with them afterwards.

   Many of the objects are simple:

   Cash, cash equivalents, loans, receivables, debt securities, payables, borrowings, and taxes payable are examples of monetary items.

   Property, plant and equipment, intangible assets, biological assets, investment property, equity investments (e.g., ordinary shares), inventories, deferred revenue, various provisions, and so on are examples of non-monetary goods.

   Some items are not that straightforward and we need to help ourselves with the definition of monetary items directly from IAS 29.12: "money kept and items to be received or paid in money".

Restatement of Assets and Liabilities

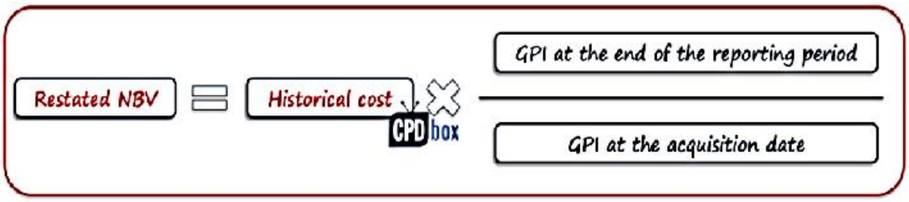
The rules for restating assets and liabilities are as follows:

Monetary assets and liabilities should not be restated because they already represent purchasing power at the conclusion of the reporting period.

The exception here are inflation-linked products such as inflation-linked bonds, which must be adjusted in accordance with the conditions of the instrument.

Non-monetary objects carried at current cost: DO NOT RESTATE. The current cost is just the value reflecting the things' current purchasing power at the conclusion of the period. Items revalued to fair value at the conclusion of the fiscal year, for example, are at their current cost.

Items carried at historical expense that are not monetary:



Restatement of equity items

Equity components at the start of the first period under IAS 29:

Revaluation surplus: totally remove it.

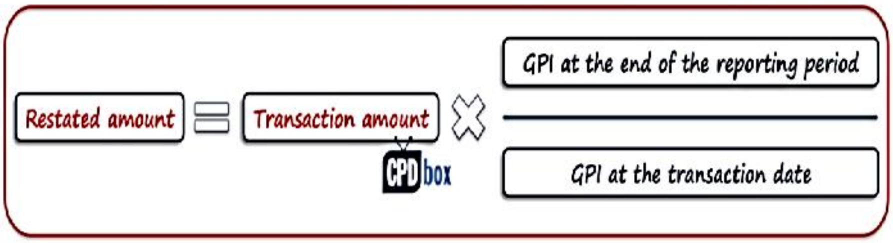
Retained earnings are derived from the revised statement of financial position's other numbers. To put it another way, this will be your balance figure.

Other equity components: restate using GPI from the dates of contribution or other purchase, however that equity component was created.

Equity components at the end of the first period under IAS AND subsequently: restate using GPI from the beginning of the period or from the date of contribution if the component originated during the year.

2.2. Restatement of profit or loss and other comprehensive income

The rule is straightforward: recast all amounts using the general price index from the transaction date.



Restatement of cash flows

The standard IAS 29 says little regarding cash flow restatement, although it does require that all items be expressed in the measuring unit that is current at the conclusion of the reporting period.

It basically implies that you must restate all of the sums, just as you would with profit or loss and other comprehensive income.

Many practical challenges and dilemmas may occur here, necessitating a great deal of judgement.

3. Restate the comparable data from the preceding reporting period.

   The same idea applies here: all things should be stated in the current measuring unit at the end of the reporting period.

   Simply apply GPI to all comparison data in this scenario.

Summary

Information about the segment contributes to the investment evaluation of corporate enterprises. Investors would be able to assess the company's earning potential, cash flows, risk, and growth. It would also help the management of the company to evaluate the internal management of the company and frame segment- specific policies. Further, while there is no precise standard for accounting for inflation, the impact on financial statements is expected to be pervasive. The standard IAS 29 is relatively ancient, having been first released in 1989 with a few additional changes. IAS 29's principal goal is to give advice on financial reporting for entities whose functional currency is the currency of a hyperinflationary economy. Simply said, the purpose is to demonstrate how much purchasing power the corporation lost on monetary things and gained on non-monetary ones.

Keywords

1. Business Segment**:** Itis a distinguishable component of an enterprise that is engaged in providing an individual product or service or or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

Factors that should be considered in determining whether products or services are related include:
(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

2. Geographical Segment**:** A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

3. Reportable segment**:** A business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard is known as a reportable segment.

4. Enterprise revenue**:** It is the revenue from sales to external customers asreported in the statement of profit and loss.

5. Segment revenue**:** Itis the aggregate of

(i) the portion of enterprise revenue that is directly attributable to a segment,

(ii) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

(iii) revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Self Assessment

1. What is the purpose of the criteria for segment identification?
A. The enterprise's decision-making process
B. External decision-makers' requirements
C. location geographically
D. Functions of operation

2. Which of the following statements concerning the 10% test is correct?
A. To decide which segments can be joined, the 10% test is utilised.
B. The 10% test is only applicable if the firm is vertically integrated.
C. The 10% test is used to identify distinguishable parts.
D. To determine reportable segments, the 10% test is utilised.

3. Segments can be combined into the "other" category if and only if:
A. Segment reporting discloses at least 10% of the enterprise's consolidated external revenues.
B. Segment reporting discloses at least 75% of the enterprise's consolidated external revenues.
C. Segment reporting discloses at least 50% of the enterprise's consolidated external revenues.
D. Segment reporting discloses at least 90% of the enterprise's consolidated external revenues.

4. Which of the following is not one of the information items that should be reported for a segment?
A. Total assets, if presented on a regular basis
B. Total gross revenues, if presented on a regular basis
C. If delivered on a regular basis, a measurement of liabilities
D. A profit/loss indicator

5. Which of the following does not apply to segment reporting?
A. Product and service descriptions for each category that produce money
B. Explanation of the foundation for segmentation
C. Identification of key management team members for each segment
D. Reporting segment item to consolidated financial statement item reconciliation

6. Which of the following are non-Monetary items :
A. cash,
B. cash equivalents,
C. loans,
D. Property.

7. Which of following is not a step under IAS 29?
A. Determine the general price index (GPI);
B. Restate the financial statements at the end of the current reporting period using that GPI; and
C. Restate the comparative information at the end of the previous reporting period.
D. Restate the vision and mission

8. Which of the following is a rule for restatement of assets and liabilities:
A. Do NOT restate at all Monetary assets and liabilities

B. restate all Monetary assets and liabilities
C. restate Monetary assets
D. restate Monetary liabilities

9. Which of the following is a rule for Non-monetary items carried at current cost:
A. Do NOT restate at all
B. restate all Non-Monetary assets and liabilities
C. restate Non-Monetary assets only
D. restate Non- Monetary liabilities only

10. Which of the following is a rule for Non-monetary items carried at historical cost:
A. Do NOT restate at all
B. restate them
C. restate Non-Monetary assets only
D. restate Non- Monetary liabilities only

11. Which of the following is true regarding restatement of Equity components at the beginning of the first period when IAS 29 is applied?
A. Revaluation surplus: keep it completely in restated financial statements
B. Retained earnings are derived from all the other amounts in the restated statement of financial position.
C. Other equity components: restate by the application of GPI
D. Retained earnings are our balancing figure

12. Which of the following is not true regarding Restatement of profit or loss and other comprehensive income?
A. Restate all the amounts by applying the general price index
B. GPI fraction will be used
C. Gain or loss on the net monetary position: You will have that as a separate line item in your profit or loss.
D. gain or loss on the net monetary position is simply the same of the gain or loss on non-monetary items

13. Which of the following is not true regarding Restatement of Restate cash flows
A. all items should be expressed in the measuring unit that is current at the end of the reporting period.
B. You need not restate all the amounts
C. Many practical issues and dilemmas may arise here and it requires lots of judgment, too.
D. The standard IAS 29 does not say much about the restatement of cash flows

14. Which of the following is not true regarding restatement the financial statements at the end of the previous reporting period (comparatives)?
A. all items should be expressed in the measuring unit that is current at the end of the reporting period.
B. simply apply GPI to all comparative numbers
C. just take GPI and apply it to all the numbers by simple mathematical calculation.

D. GPI fraction is necessary to use.

15. The only accounting standard dealing with inflation is

A. AS 18
B. IAS 29
C. IFRS12
D. IFRS 13

Answers for Self Assessment

1.	A	2.	D	3.	B	4.	B	5.	C
6.	D	7.	D	8.	A	9.	A	10.	B
11.	A	12.	A	13.	B	14.	D	15.	B

Review Questions

1) What are financial reporting practices in Hyperinflationary Economy as per IAS 29?
2) How are the financial statements restated at the end of the current reporting period under IAS 29?
3) How are equity items restated under IAS 29?
4) How are profit or loss and other comprehensive income restated at the end of the current reporting period under IAS 29?
5) Write a note on segment reporting.

Further Readings

A text book on International Accounting and Reporting Issues: 2018 Review by United Nations Conference on Trade and Development (UNCTAD) · 2019

A text book on Dual Reporting for Equity and Other Comprehensive Income by Francesco Bellandi

Web Links

https://cleartax.in/g/terms/inflation-accounting

https://abmagazine.accaglobal.com/global/articles/2022/jun/technical/accounting-for-inflation.html

https://www.cpdbox.com/ifrs-reporting-in-hyperinflationary-economy-ias-29/

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Unit 09: Accounting for Foreign Currency Transactions And Translation

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the conceptual challenges inherent in interpreting financial statements in a foreign currency.
- Describe the differences between transaction exposure and exposure on the balance sheet.
- Explain the theoretical underpinnings of the existing rate and temporal translation techniques.
- Use the temporal and current rate translation procedures, and compare the outcomes of the two.
- Outline the appropriate International Financial Reporting Standards (IFRS) and generally accepted accounting principles (GAAP) requirements (GAAP).
- Go through exposure on the balance sheet hedging.

Introduction

Numerous businesses operate abroad in the modern global business climate. Ford Motor Company offered a list of subsidiaries with addresses in about 20 different nations worldwide in its 2012 10-K filing. Volkswagen AG, a German carmaker, claims to have fully owned subsidiaries in more than 50 nations other than Germany. Many businesses with international operations maintain accounting records and create financial statements in the local currency based on local accounting standards. In order to create consolidated financial statements, parent companies must first translate their foreign subsidiaries' financial statements into the reporting currency of the parent company before restating the statements in accordance with the parent company's reporting generally accepted accounting principles (GAAP).In the current global business environment, many companies do operations abroad. In its 2012 10-K filing, Ford Motor Company included a list of subsidiaries with addresses in around 20 different countries around the world. The German automaker Volkswagen AG asserts to have completely owned subsidiaries in more than 50 additional countries. Numerous companies that conduct business internationally keep accounting records and produce financial statements in the local currency in accordance with local accounting norms. Parent companies must first translate the financial statements of their foreign subsidiaries into the parent company's reporting currency before restating the statements in accordance with the parent company's reporting generally accepted accounting principles in order to create consolidated financial statements (GAAP).

9.1 Translation Methods

The current/noncurrent method, the monetary/nonmonetary method, the temporal method, and the current rate (or closing rate) method are the four most widely used techniques for converting foreign currency financial statements.

Current/Noncurrent Method

The current/noncurrent approach has the following rules: noncurrent assets, noncurrent liabilities, and stockholders' equity statements are translated at historical exchange rates; current assets and current liabilities are translated at the current exchange rate. This technique has no theoretical foundation. The current/noncurrent technique was once the most popular one, but it has been prohibited in the United States since 1975, is never permitted by the International Financial Reporting Standards, and is rarely used in other nations.

Monetary/Nonmonetary Method

Hepworth created the monetary/nonmonetary technique of translation in 1956 to address the current/noncurrent approach's lack of theoretical justification.

This approach converts financial assets and liabilities at the current exchange rates; non-financial accounts are translated using historical exchange rates for non-financial assets, non-financial liabilities, and stockholders' equity.

The term "monetary assets" refers to assets, particularly cash and receivables, whose value does not fluctuate over time.

Assets with a fluctuating monetary worth are considered nonmonetary assets. Marketable securities, inventory, pre-paid expenses, investments, and fixed assets are among them.

All assets—including intangible assets—aside from cash and receivables.

Most payables fall under the category of monetary liabilities since their dollar values cannot change over time.

The cash, receivables, and payables listed on the balance sheet of the foreign operation are subject to foreign exchange risk under the monetary/nonmonetary method.

When cash plus receivables exceed payables, there is a net asset exposure, and when payables exceed cash plus receivables, there is a net liability exposure.

Cash + Receivables >Payables → Net asset exposure

Cash + Receivables Payables → Net liability exposure

By assuming that the cash, receivables, and payables of the international operation are actually assets and liabilities in foreign currencies of the parent company, it is possible to comprehend the concept of exposure underlying the monetary/nonmonetary technique.

Take the Japanese division of a New Zealand parent business, for instance.

It is possible to think of the Japanese yen receivables of the New Zealand parent resulting from export sales to Japan as the yen receivables of the Japanese subsidiary that arise from sales in Japan.

A rise in the value of the yen would lead to a foreign exchange gain if the New Zealand parent had yen receivables on its balance sheet.

The parent's cash-held Japanese yen would likewise have a foreign exchange gain. These foreign exchange gains would be counterbalanced by a foreign exchange loss on the parent's foreign-purchased Japanese yen payables.

The ratio of yen cash and receivables to yen payables determines whether there is a net gain or loss. The translation adjustment calculates the net foreign exchange gain or loss on the cash, receivables, and payables of the overseas operation as if they were actually recorded on the parent's books. This is known as the monetary/nonmonetary technique.

Temporal Method

The primary goal of the temporal technique of translation is to generate a set of translated financial statements into the parent currency that appear as though the foreign subsidiary had actually used the parent currency in its operations.

For instance, land that is recorded on a foreign subsidiary's books should be translated such that it appears on the consolidated balance sheet at the amount of parent currency that would have been used if the parent had paid parent currency to the subsidiary to buy the land.

Assume the price of the land is 12,000,000 and it is purchased when one yen is equal to NZ$0.016.

The land's historical cost in parent currency is NZ$192,000, which a New Zealand parent would give to its Japanese subsidiary to purchase the land.

Assets and liabilities presented on the balance sheet of the foreign operation at historical cost are translated at historical exchange rates to provide an equivalent historical cost in parent currency terms.

This is in line with the basic purpose of the temporal approach.

On the other hand, assets and liabilities presented on the balance sheet of the foreign operation at a current (or future) value are converted at the current exchange rate to produce an equivalent current value in terms of the parent currency.

Equity accounts are translated using historical exchange rates, as is the case with all translation methods.

When these regulations are followed, the foreign subsidiary's underlying asset and liability valuation method (historical cost or current value) is maintained.

Under the conventional historical cost model of accounting, cash, receivables, and the majority of liabilities are carried at current or future values. Under the temporal technique, these balance sheet accounts are converted at the going rate of currency.

By chance, in this case, both the temporal method and the monetary/nonmonetary method provide comparable outcomes. When non-monetary assets are carried at their present value, only one of the two techniques diverges from the other.

Inventory must be reported on the balance sheet at the lower of historical cost or current market value, according to many national accounting standards. Despite being a non-monetary asset, inventory must be translated using the current exchange rate when it is written down to market value according to the temporal method. Marketable securities are also translated at the current exchange rate in those nations where marketable securities must be carried at current market value in accordance with International Financial Reporting Standards (IFRS) and U.S. GAAP.

Depending on whether assets carried at current value are larger than or less than liabilities carried at current value, the temporal technique produces either a net asset or a net liability balance sheet exposure. This can generally be said to be:

Cash +Marketable securities +Receivables+ Inventory (when carried at current value)> Liabilities →Net asset exposure

Cash Marketable securities+ Receivables+ Inventory (when carried at current value) < Liabilities→ Net liability exposure

When using the temporal technique, there is frequently a net liability exposure since liabilities (current plus long-term) are typically more than assets translated at current rates.

The income statement items are translated using the exchange rates in effect at the time the revenue is produced or the expense is incurred using the temporal approach.

For the majority of items, it is reasonable to assume that revenue or expense is incurred consistently over the course of the accounting period, and translation can be done using an average exchange rate for the period.

Some expenses are connected to assets carried at historical cost, including cost of goods sold, fixed asset depreciation, and amortisation of intangibles.

The costs associated with these assets must also be translated at historical exchange rates because they are being valued at historical exchange rates.

The translation adjustment resulting from the application of the temporal technique differs significantly from a gain or loss on foreign exchange on a foreign currency transaction in that it is not always realised through inflows or outflows of cash only if

(1) the foreign subsidiary collects all of its receivables in yen cash and uses its cash to pay down liabilities to the greatest degree practicable will the translation adjustment be realised as a gain or loss.

(2) In the event of a net asset exposure, the excess of cash over liabilities is transferred to the parent, where it is converted into parent currency. In the event of a net liability exposure, the parent transfers parent currency to its foreign subsidiary, which is then converted into foreign currency to settle the outstanding liabilities.

Current Rate Method

The current rate method is the fourth important technique for converting financial statements in foreign currencies.

The essential idea of the current rate technique is that a parent's total investment in a foreign enterprise is treated as a single investment.

The current rate method is the fourth important technique for converting financial statements in foreign currencies.

A parent's entire investment in a foreign business is subject to foreign exchange risk, and the financial statements of the foreign operation should be translated to reflect this risk, according to the core idea of the current rate method.

All foreign operating assets and liabilities are translated using the current currency rate, and equity accounts are translated using historical exchange rates, in order to calculate the net investment's exposure to foreign exchange risk.

The net asset position of the foreign operation equals the balance sheet exposure calculated using the current rate approach (total assets minus total liabilities).

Total assets > Total liabilities → Net asset exposure

When the foreign currency increases in value, there is a positive translation adjustment; when it decreases, there is a negative translation adjustment (assuming that assets exceed liabilities). The current rate technique also results in an unrealized translation adjustment. If the overseas enterprise is sold (for its book value) and the foreign currency sales proceeds are converted into the parent currency, it can become a realised gain or loss.

Revenues and costs are translated using the exchange rate in place at the time of accounting recognition when employing the current rate technique.

In most circumstances, it is possible to apply an average-for-the-period exchange rate and assume that the revenue or expense is spread out equally over the course of the year.

However, the exchange rate at that moment should be utilised for translation when an income item, such as a gain or loss on the sale of an asset, occurs at a certain point in time.

Alternately, all items on the income statement could be converted at the going rate.

The two approaches that must be utilised in accordance with IAS 21, The Effects of Changes in Foreign Exchange Rates, and FASB ASC 830, Foreign Currency Matters, are the current rate method and the temporal method.

Exchange Rates Used under the Current Rate Method and the Temporal Method for Selected Financial Statement Items

Balance Sheet	Exchange Rate Used under the Current Rate Method	Exchange Rate Used under the Temporal Method
Assets		
Cash and receivables	Current	Current
Marketable securities	Current	Current*
Inventory at market	Current	Current
Inventory at cost	Current	Historical
Prepaid expenses	Current	Historical
Property, plant, and equipment	Current	Historical
Intangible assets	Current	Historical
Liabilities		
Current liabilities	Current	Current
Deferred income	Current	Historical
Long-term debt	Current	Current
Stockholders' Equity		
Capital stock	Historical	Historical
Additional paid-in capital	Historical	Historical
Retained earnings	Historical	Historical
Dividends	Historical	Historical

Income Statement	Exchange Rate Used under the Current Rate Method	Exchange Rate Used under the Temporal Method
Revenues	Average	Average
Most expenses	Average	Average
Cost of goods sold	Average	Historical
Depreciation of property, plant, and equipment	Average	Historical
Amortization of intangibles	Average	Historical

*Marketable debt securities classified as hold-to-maturity are carried at cost and therefore are translated at the historical exchange rate under the temporal method.

Translation of Retained Earning

Both the temporal and current rate techniques convert stockholders' equity items using previous exchange rates. This makes it fairly difficult to translate retained earnings, which represent a collection of numerous prior transactions, including revenues, expenses, gains, losses, and declared dividends during the course of the company's existence. Foreign currency retained earnings (FC) at the end of the first operating year are translated as follows.

Net income in FC		
[Translated per method used to translate income statement items] =		+Net income in PC
Less:Dividends in FC x Historical exchange rate when declared	=	Dividends in PC

Ending R/E in FCEnding R/E in P

The translated retained earnings in Year 2 (and succeeding years) are then calculated as follows: The ending parent currency retained earnings in Year 1 become the commencing parent currency retained earnings for Year 2.

Beginning R/E in FC (from last year's translation)	=	Beginning R/E in PC
+Net income in FC		
[Translated per method used to translate income statement items]	=	+Net income in FC
Less:Dividends in FC x Historical exchange rate when declared	=	-Dividends in PC
Ending R/E in PCEnding R/E in PC		

Retained earnings are translated using the same process for both the temporal method and the current rate method. The sole distinction between the two approaches is how the net income for the current period is translated.

9.2 Aspects of the Temporal Method that are Complicated

The inventory, prepaid expenses, fixed assets, and intangible assets that are carried at historical cost are translated at historical exchange rates, therefore under the temporal method, it is required to maintain track of the currency rates that are in effect when these assets are acquired. Under the current rate technique, it is not necessary to keep track of previous rates for these assets. Application of the temporal technique is more difficult than the current rate method when translating these assets at historical rates.

Calculation of Cost of Goods Sold (COGS)

The current rate technique simply converts the cost of goods sold (COGS) in foreign currency (FC) into the parent currency (PC) using the average exchange rate (ER) for the period:

COGS in FC x Average ER = COGS in PC

Beginning inventory in FC x	Historical ER ((e.g 4thQ Year 1)=	Beginning inventory in PC
+Purchases in FC	X Average ER Year 2	= +Purchases in PC
-Ending inventory in FC	x Historical ER (e.g 4thQ Year 2) =-	Ending inventory in PC
COGS in FCCOGS in PC		

COGS in FC cannot be easily converted into COGS in PC using a single exchange rate.

The Lower of Cost or Market Rule

- Whether carrying inventory at cost or at a lower market value, the ending inventory reported on the foreign currency balance sheet is translated at the current exchange rate.
- The lower of the parent currency cost or parent currency market value is reported on the consolidated balance sheet when the temporal method is applied, which requires that the foreign currency cost and foreign currency market value of the inventory be translated into parent currency at appropriate exchange rates.

- This process makes it possible to carry inventory at cost on the balance sheet in the foreign currency and at market value on the consolidated balance sheet in the parent currency, and vice versa.

Fixed Assets, Depreciation, Accumulated Depreciation

The temporal technique requires that fixed assets purchased at various dates be converted at various (historical) exchange rates. The same is true for accumulated depreciation related to fixed assets and depreciation on fixed assets.

9.3 Translation Adjustment Disposition

International Financial Reporting Standards

IAS 21, The Effects of Changes in Foreign Exchange Rates, provides instructions on how to translate financial statements made in foreign currencies. IAS 21 originally mandated that overseas subsidiaries be classified as either

(1) foreign operations that are important to the reporting enterprise's operations or

(2) foreign entities in order to establish the best translation technique.

IAS 21 was updated in 2003 as part of a larger reform project, using the functional currency strategy created years earlier by the FASB.

The updated standard defines functional currency as the main form of money used by a subsidiary's operating environment.

It may be the same currency that the parent uses to deliver its financial statements, a separate foreign currency, or neither. IAS 21 offers a list of variables to take into account while choosing the functional currency (shown in Exhibit 8.3).

IAS 21 offers a hierarchy of primary and secondary variables to be taken into account in determining the functional currency of a foreign subsidiary, in contrast to U.S. GAAP. Additionally, there are a few variances between the criteria that must be taken into account under IFRS and U.S. GAAP. Due to these variations, a foreign subsidiary can be considered to have one functional currency under IFRS but a different functional currency under U.S. GAAP.

According to IAS 21, a foreign subsidiary's financial statements that have a functional currency that differs from the parent's reporting currency must be translated using the current rate method, with the resulting translation adjustment being reported as a separate component of stockholders' equity. The cumulative translation adjustment for a particular foreign subsidiary is moved to income in the same period that the gain or loss on disposal is reported when a foreign subsidiary is sold. The financial statements of a foreign subsidiary whose functional currency is the same as the reporting currency of the parent are translated using the temporal technique, and the resulting translation adjustment is reported now as a gain or loss in income. U.S. GAAP calls for the same combinations.

IAS 21 stipulates that for foreign subsidiaries whose functional currency is the currency of a hyperinflationary economy, the parent must first restate the foreign financial statements for inflation in accordance with the guidelines in IAS 29, Financial Reporting in Hyperinflationary Economies, before translating the statements into parent company currency using the current exchange rate.

All accounts on the balance sheet, including stockholders' equity, and all accounts on the income statement are converted using the current exchange rate.

This strategy differs significantly from U.S. GAAP, which mandates the temporal method for translating the financial statements of a foreign subsidiary operating in a highly inflating economy.

IAS 29 does not define hyperinflation specifically, but it argues that an economy is hyperinflationary if its cumulative three-year inflation rate is close to or greater than 100%.

9.4 Factors Taken into Account When Choosing the Functional Currency

IAS 21: The Effects of Changes in Foreign Exchange Rates states that:

The following elements ought to be taken into account first when deciding on a unit's functional currency:

1. The currency of the country whose competitive forces and regulations primarily determine the sales price of its products and services and (a) that primarily influences sales pricing for goods and services.

2. The currency that primarily influences the costs of labour, materials, and other expenses associated with delivering goods and services.

The following secondary elements must be taken into account if the primary factors mentioned above are mixed and the functional currency is not clear:

3. The currency that is used to transact financial transactions.

4. The currency that operations activity revenues are often kept in.

5. Whether the overseas operation's operations are carried out with a significant amount of autonomy or as an extension of the parent's.

6. The amount of the foreign entity's activities that are made up of transactions with the parent.

7. Whether the overseas operation's cash flows directly impact the parent's cash flows and are transferable to the parent.

8. Whether the overseas operation's operating cash flows are sufficient to pay down its debt as it currently stands and as would be expected, or whether it will require money from the parent to do so.

9.5 Financial Statements Translation: Current Rate Method

Finding the functional currency is the first step in translating foreign currency financial statements.

The income statement and statement of retained earnings would be converted into U.S. dollars using the current rate technique, presuming that the euro is the functional currency.

At the time of accounting recognition, all revenues and expenses are converted at the current exchange rate.

Because each income and expense in this demonstration would have been recognised evenly throughout the year, the weighted-average exchange rate for Year 1 is used.

However, the exchange rate in effect on that date is used when an income account, such as a gain or loss, occurs at a specific period.

The average annual rate is often used to translate the costs associated with depreciation and amortisation. Despite the fact that the journal entry may have been put off until year-end for convenience, these costs accrue consistently throughout the year.

The income statement's translated net income for Year 1 is moved to the statement of retained earnings. The currency rate in effect on the declaration date is used to convert dividends.

Balance Sheet Translation

The current exchange rate is used to translate all assets and liabilities.

The capital stock is converted using the exchange rate in effect at the time of issuance.

The first year's retained earnings are reduced from the statement of retained earnings.

The translation adjustment's sign (positive or negative) depends on two things:

(1) The type of exposure on the balance sheet (asset or liability) and

(2) The trend of the exchange rate (appreciation or depreciation)

One can derive the translation adjustment as a balancing formula that restores the equilibrium of the balance sheet. The influence of exchange rate fluctuations on the starting balance and subsequent changes in the net asset position can also be taken into account when calculating the translation adjustment. The actions listed below are used:

1. The subsidiary's net asset balance at the start of the year is converted using the exchange rate in effect at that time.
2. Throughout the year, specific increases and falls in the net asset balance are translated at the rates in place at the time of those occurrences. Only a few number of things (such net income, dividends, stock issuance, and the purchase of treasury shares) actually affect net assets. Total net assets are unaffected by acts such as the purchase of equipment or the settlement of a liability.
3. To determine the relative worth of the net assets held before the effects of any exchange rate fluctuations, the translated beginning net asset balance (a) and the translated value of the individual changes (b) are then summed.
4. To determine the reported value after all exchange rate adjustments have taken place, the ending net asset balance is next translated at the current exchange rate.
5. The ending translated value is compared to the translated value of the net assets before any rate adjustments (c) (d). Exchange rate fluctuations throughout the time period are what caused the disparity. A negative (debit) translation adjustment occurs if (c) is higher than (d). A positive (credit) translation adjustment happens if (d) exceeds (c).

9.6 Remeasuring Financial Statements Bytemporal Method

The financial statements for the euro will be converted into dollars using the temporal approach, and any gains or losses from the conversion will be included in income. It is simpler to remeasure the balance sheet first to make sure that the remeasurement gain or loss is reported in income.

Remeasuring Income Statement

Sales, selling and administrative costs, interest costs, and income taxes are just some of the costs and revenues that are evenly distributed throughout the year and remeasured at the average exchange rate. Depreciation and amortisation costs for assets that are remeasured at historical exchange rates are themselves remeasured at pertinent historical rates.

Remeasurement of cost of goods sold is done using past exchange rates. Beginning inventory is that which is bought on January 1 and measured using the exchange rate as of that day. Since purchases were spread out equally over the course of the year, they are remeasured at the annual average rate. The cost of goods sold for ending inventory (at FIFO cost) was remeasured using the average exchange rate for the month of December. Ending inventory was evenly acquired throughout the month.

Both the balance sheet's ending balance in retained earnings and the statement of retained earnings must add up to the same amount.

The income statement, statement of retained earnings, and balance sheet will not be consistent with one another without this remeasurement gain.

The remeasurement gain can be computed by taking into account the vulnerability of the subsidiary's balance sheet to changes in exchange rates. The net monetary asset or net monetary liability position of the balance sheet serves as the measure of balance sheet exposure under the temporal technique.

The beginning net monetary asset position and subsequent changes in monetary items are translated at the appropriate exchange rates, and the remeasurement gain is calculated by comparing these results to the net monetary liabilities' U.S. dollar value at year's end based on the current exchange rate.

Hedging Of Balance Sheet Exposure

Remeasurement gains and losses shall be recognised in the consolidated income statement when it is decided that a foreign operation uses the parent's reporting currency as its functional currency or is located in an economy with a high rate of inflation.

Because of the anticipated negative effect that reporting remeasurement losses in income has on the company's stock price or the negative influence on incentive compensation, management of international corporations may desire to avoid doing so.

Additionally, due to the negative effects on ratios like the debt-to-equity ratio, management may want to avoid disclosing negative translation adjustments in shareholders' equity when the international operation uses a foreign currency as its functional currency.

Changes in the exchange rate and balance sheet exposure are two factors that affect translation adjustments and remeasurement gains/losses.

Although individual businesses are powerless to influence exchange rates, parent firms can utilise a number of strategies to reduce the exposure of their foreign units' balance sheets.

Each of these strategies entails establishing a balance between foreign asset and foreign liability balances that are converted at the current exchange rates.

Consider the scenario where the euro is a company's functional currency; this results in a net asset balance sheet exposure.

The business anticipates that during the course of the following year, the euro will depreciate, leading to a negative translation adjustment that will lower consolidated stockholders' equity.

By taking out a temporary euro loan, the company can offset its balance sheet risk by taking on a temporary euro debt. A foreign exchange gain on the euro liabilities will result from the euro's decline, offsetting the negative translation adjustment brought on by the translation of the company's financial statements.

To lessen its exposure on its balance sheet, company might have purchased a euro call option instead of borrowing the currency. The fair value of the call option should rise as the value of the euro drops, resulting in a profit.

The gain or loss on a hedging instrument that is designated and effective as a hedge of the net investment in a foreign operation must be reported in the same way as the translation adjustment it is intended to cover, according to both IFRS and U.S. GAAP.

In other comprehensive income, coupled with the negative translation adjustment brought on by the translation of co's financial statements, would be the foreign exchange gain on the euro borrowing or the gain on the foreign currency option.

This is a deviation from the standard practise of transferring foreign exchange gains and losses directly to net income. The excess is added to net income if the gain on the hedging instrument exceeds the translation adjustment being hedged.

The paradox of hedging a balance sheet exposure is that in order to prevent an unrealized translation adjustment, realised profits and losses in foreign exchange can occur.

Summary

The two main concerns when translating financial statements into foreign currencies are (a) which technique to apply and (b) where to report the resulting translation adjustment in the consolidated financial statements. There are different translation techniques depending on whether the accounts are translated using the current exchange rate or historical rates. Translation adjustment may apply to accounts translated at the current currency rate. Different translation techniques result in various conceptions of balance sheet exposure as well as translation modifications with varying sign and magnitude. Under Current Rate method Positive translation adjustment will be produced by currency appreciation. A negative translation adjustment will arise from the foreign currency depreciating. The current rate technique distorts the underlying valuation method employed by the foreign operation by converting assets carried at historical cost at the current exchange rate while maintaining linkages between account balances in the foreign currency financial statements. Under temporal method a negative translation adjustment will arise from the foreign currency

appreciating (remeasurement loss). A positive translation adjustment (remeasurement gain) will be produced by a decline in the value of the foreign currency. The temporal technique retains the underlying valuation method employed by the foreign operation but distorts relationships between account balances in the foreign currency financial statements by translating (remeasuring) assets carried at historical cost at historical exchange rates.By determining the functional currency of a foreign operation, the proper combination of translation technique and disposition of translation adjustment is established under both IFRS and U.S. GAAP. The current rate technique is used to translate the financial statements of foreign operations whose functional currency differs from the parent's reporting currency, with the translation adjustment being added to shareholders' equity. The temporal technique is used to translate the financial statements of foreign operations whose functional currency coincides with the parent's reporting currency, with the resulting translation gain or loss being shown in net income at the time of translation.

Keywords

Current Rate method: The current rate technique results in a net asset balance sheet exposure since all assets and liabilities are converted at the current exchange rate.

Temporal rate method: Liabilities are translated (remeasured) at the current exchange rate for assets carried at current or future value (cash, marketable securities, receivables). Stockholders' equity and assets carried at historical cost are translated (remeasured) using historical currency rates. A net liability balance sheet exposure exists when liabilities exceed the total of cash, marketable securities, and receivables.

Self Assessment

1. Which of the following statements is wrong in regard to hedging of balance sheet exposures?

A. Some companies hedge their balance sheet exposures to avoid reporting remeasurement losses in income

B. Some companies hedge their balance sheet exposures to avoid negative translation adjustments in stockholders' equity.

C. Foreign exchange gains and losses on foreign currency borrowings or foreign currency derivatives employed to hedge translation based exposure (under the current rate method) are treated as part of the cumulative translation adjustment in stockholders' equity.

D. Foreign exchange gains and losses on balance sheet hedges used to hedge remeasurement-based exposure (under the current rate method) are offset against remeasurement gain and losses on the income statement

2. Which of the following statements is wrong in regard to current rate method?

A. Under the current rate method, all assets and liabilities are translated at the current exchange rate, giving rise to a net asset balance sheet exposure.

B. Appreciation in the foreign currency will result in a negative translation adjustment.

C. Depreciation in the foreign currency will result in a negative translation adjustment.

D. By translating assets carried at historical cost at the current exchange rate, the current rate method maintains relationships that exist among account balances in the foreign currency financial statements

3. The only substantive difference in translation rules between IFRS and U.S. GAAP relates to foreign operations that report in the currency of a ……….economy.

A. Hyperinflationary

B. Inflationary

C. Deflationary
D. boom

4. ……requires the parent first to restate the foreign financial statements for inflation using rules in IAS 29 and then to translate the statements into parent-company currency using the current rate method.

A. ASB ASC 830
B. IAS 21
C. IAS 29
D. None of these

5. ……Requires the financial statements of foreign operations that report in the currency of a highly inflationary economy to be translated using the temporal method, as if the U.S. dollar were the functional currency.

A. ASB ASC 830
B. IAS 21
C. IAS 29
D. None of these

6. A country is considered highly inflationary if its cumulative three-year inflation rate exceeds ….. percent.

A. 100
B. 200
C. 200
D. 500

7. Which of the following statements is wrong in regard to temporal method?

A. Under the temporal method, assets carried at current or future value (cash, marketable securities, receivables) and liabilities are translated (remeasured) at the current exchange rate.
B. Assets carried at historical cost and stockholders' equity are translated (remeasured) at current exchange rates.
C. When liabilities are greater than the sum of cash, marketable securities, and receivables, a net liability balance sheet exposure exists.
D. Appreciation in the foreign currency will result in a negative translation adjustment (remeasurement loss).

8. Which of the following is wrong regard to translation issues?

A. The one major issue related to the translation of foreign currency financial statements is which method should be used, and
B. Another major issue related to the translation of foreign currency financial statements is where the resulting translation adjustment should be reported in the consolidated financial statements.
C. Translation methods do not differ on the basis of which accounts are translated at the current exchange rate and which are translated at historical rates.
D. Accounts translated at the current exchange rate are exposed to translation adjustment.

9. …………also requires companies to provide information related to their cumulative translation adjustments

A. IAS 20

B. IAS 21

C. IAS 22

D. IAS 23

10. The ……… currency is the primary currency of the foreign entity's operating environment. It can be either the parent's currency (US$) or a foreign currency (generally the local currency).

A. Functional

B. Non-Functional currency

C. Temporal currency

D. Current currency

11. The ………….is the currency in which the entity prepares its financial statements.

A. Reporting currency

B. Functional

C. Non-Functional currency

D. Temporal currency

12. Which of the following statements is wrong?

A. If a foreign operation's functional currency is the U.S. dollar, foreign currency balances must be remeasured into U.S. dollars using the temporal method,

B. When a foreign currency is the functional currency, foreign currency balances are translated using the current rate method and a translation adjustment is reported on the balance sheet.

C. When a foreign currency is the functional currency, foreign currency balances are translated using the historical rate method and a translation adjustment is reported on the balance sheet.

D. If a foreign operation's functional currency is the U.S. dollar, foreign currency balances must be remeasured into U.S. dollars using the temporal method, with translation adjustments reported as remeasurement gains and losses in income.

13. Which of the following statements is right in regard to disposition of translation adjustment?

A. the translation adjustment is considered to be a gain or loss analogous to the gains and losses that arise from foreign currency transactions and should be reported in other comprehensive income in the period in which the fluctuation in exchange rate occurs

B. The alternative to reporting the translation adjustment as a gain or loss in net income is to include it in stockholders' equity as a component of other comprehensive income

C. The alternative to reporting the translation adjustment as a gain or loss in net income is to include it in stockholders' equity as a component of deferred shares

D. The alternative to reporting the translation adjustment as a gain or loss in net income is to include it in stockholders' equity as a component of cash flow statement

14. Keeping track of the historical rates of inventory, prepaid expenses, fixed assets, and intangible assets

A. Not necessary under the current rate method.
B. necessary under the current rate method.
C. Not necessary under the current rate as well as temporal method.
D. Not necessary under the temporal method.

15. Which of the following is right in regard to Calculation of Cost of Goods Sold (COGS) under temporal method?
A. Under the current rate method, cost of goods sold (COGS) in foreign currency (FC) is simply translated into the parent currency (PC) using the average-for-the-period exchange rate (ER)
B. Under the current rate method, cost of goods sold (COGS) in foreign currency (FC) is simply translated into the parent currency (PC) using the current exchange rate (ER)
C. Under the current rate method, cost of goods sold (COGS) in foreign currency (FC) is simply translated into the parent currency (PC) using the historical exchange rate (ER)
D. Under the current rate method, cost of goods sold (COGS) in foreign currency (FC) is not translated into the parent currency (PC)

Answers for Self Assessment

1.	D	2.	B	3.	A	4.	B	5.	A
6.	A	7.	B	8.	C	9.	B	10.	A
11.	A	12.	C	13.	B	14.	A	15.	A

Review Questions

1) What elements lead to a translation's exposure to foreign exchange risk on the balance sheet? How does transaction exposure compare to exposure on the balance sheet?
2) What idea underlies the translation mechanism that is now used by rates? What idea underlies the temporal approach to translation? How do these two approaches affect balance sheet exposure differently?
3) What are the main methodological distinctions between using the present temporal and rate methods of translation?
4) How does a parent business choose the best strategy for translating a foreign subsidiary's financial statements?
5) In translating financial accounts in foreign currencies, what are the main differences between IFRS and U.S. GAAP?

Further Readings

- International Accounting by Timothy Doupnik, University of South Carolina and Hector Perera ,Macquarie University, Fourth Edition
- https://www.cpdbox.com/ias21-foreign-exchange-rates/

Dr. Rupinder Katoch, Lovely Professional University

Unit 10:Issues Related to Consolidation of Financial Statements of MNC's

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss the numerous concerns surrounding the creation of consolidated financial statements and the accounting for company combinations (group accounting).
- Describe the strategies employed globally to overcome the problems associated with group accounting, with a focus on IFRS.

Introduction

A business combination is the acquisition of one business by another and is part of what is commonly referred to as mergers and acquisitions (M&A) activity. Business combinations are the major vehicle through which MNCs expand their international business operations. For example, in 2006 there were more than 13,000 M&A transactions worldwide, and about half, with a combined value of US$1.49 trillion, were completed by entities that applied U.S. GAAP. Most of the rest, worth about US$1.82 trillion, were completed by entities that applied IFRS or were moving to IFRS. Businesses can combine their operations in a number of different ways. In many cases, the company being acquired in a business combination is legally dissolved as a separate legal entity. Either the acquired company goes out of existence and is merged into the acquiring company, or both parties to the combination are legally dissolved and a new company formed to take their place. In yet a third method of combination, one company gains control over another company by acquiring a majority of its voting shares, but the acquired company continues its separate legal existence. In this case, the acquirer becomes the parent company and the acquiree becomes the subsidiary company. Here no company goes out of existence, and both the parent and the subsidiary continue to operate as separate legal entities, maintaining their own accounting records and preparing their own financial statements. Since multinational businesses (MNCs) frequently function as groups, consolidated financial statements that accurately depict their financial status and performance are necessary.

This third sort of corporate combination typically falls under the definition of a "group." A group is defined under IAS 27 (Consolidated and Separate Financial Statements) as the parent and all of its subsidiaries, and it mandates that parents provide consolidated financial statements. The following topics regarding the accounting for company combinations and the creation of consolidated financial statements are covered in this part, with an emphasis on IFRS:

1. Establishing control.

2. The consolidation's scope.

3. Complete consolidation using the purchase method and goodwill accounting.

4. Equivalent consolidation

5. Equity approach.

10.1 Definition of Group and Subsidiary

- According to IFRS 3, a group consists of a parent and any subsidiaries, and groups must create consolidated financial statements.
- IAS 27 mandates that a parent consolidate all of its domestic and international subsidiaries, unless management is actively looking for a buyer for a company that was acquired with the aim of being sold within the next 12 months.
- The definition of a subsidiary is founded on the idea of control, which is frequently explained in terms of having legal control over a company through a majority shareholding.
- IAS 27 also acknowledges that effective control might exist in the absence of legal control, for instance, through a contractual arrangement.
- Consolidation of effectively controlled subsidiaries is necessary.

10.2 Establishing Control

Legal control, which is typically represented by ownership of more than 50% of the shares and voting rights of another corporation, is a common foundation for the concept of a group.

Shares expressing control may have direct or indirect ownership (through other controlled subsidiaries).

A contract that brings one business under the legal control of another, which might not have 50% of the voting shares, is another way to gain legal control.

Such control arrangements, for example, are permitted by German corporate law.

Other than majority ownership, a firm can effectively control another company.

Effective control can also be obtained through board representation or by widely distributed stock ownership.

For example, if Company A holds 45 percent of Company B's voting shares and the remaining 55 percent is owned by thousands of minor investors who do not vote, Company A will be able to control Company B.

In such instances, even though the investor does not control more than 50% of the investee's shares, it may be appropriate to consolidate the investee's financial statements with those of the investor.

In South Korea, for example, it is typical for firms to combine investees when the investment company owns more than 30% of the outstanding voting stock and is the largest single shareholder.

IAS 27 demands the consolidation of all subsidiaries and defines a subsidiary as a business controlled by another, known as the parent.

Control is defined as

"the power to regulate an entity's financial and operating rules in order to reap benefits from itsactions" .

In essence, IAS 27 favours content above form when it comes to the concept of control.

It recognises that an investor who owns less than 50% of another company's stock may nevertheless have control if the investor has power.

Through agreements with other shareholders, shareholders possess more than half of the voting power.

- To establish the business's financial and operational policies in accordance with current laws or agreements.
- To appoint or dismiss the majority of the governing body's members (the board of directors or a comparable group).
- To vote in favour of the motion in meetings of the corporate council.

In other words, the IASB defines control as "exclusive rights over an entity's assets and liabilities that provide access to their benefits and the power to raise, preserve, or safeguard the amount of those advantages."

US GAAP (Accounting Research Bulletin 51) employs controlling fi nancial interest as its consolidation requirement without defining what controlling entails.

Historically, majority stock ownership has been used to demonstrate control in US corporations.

However, in the case of so-called special purpose corporations, FASB Interpretation 46, Consolidation of Variable Interest Entities, has recently enlarged the concept of control to one based on effective control.

One or more of the following are indications of a controlling financial interest in a variable interest (special purpose) entity:

- The power to directly or indirectly decide on how the firm will conduct its business.
- The commitment to cover the entity's anticipated losses should they materialise.
- The right to obtain the entity's anticipated residual profits, should they materialise.

Control over this kind of entity is determined independently of ownership level.

The replacement of their current frameworks with the better conceptual framework for financial reporting is the ultimate goal shared by the IASB and FASB.

Exposure Draft (ED/2010/2) titled "Conceptual Framework for Financial Reporting—The Reporting Entity" was published by the IASB in March 2010. "

An entity controls another entity when it has the ability to direct that other entity's activities to produce benefits for itself," the statement reads (or limit losses to)itself.

When a controlling entity creates financial reports, the reports should include consolidated financial statements.

Additionally, it distinguishes between "control" and "signifi cant influence," stating that "if one entity has significant influence over another entity, it does not dominate that other entity."

The capacity of an entity to influence another entity's actions without actually

Power over the other entity does not exist simply because you can guide those activities. It is evident that the IASB's approach to defining control was one based on principles as opposed to regulations, or one that was qualitative as opposed to quantitative.

In other words, the IASB defines control as "exclusive rights over an entity's assets and liabilities that provide access to their benefits and the power to raise, preserve, or safeguard the amount of those advantages."

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However, in the case of so-called special purpose corporations, FASB Interpretation 46, Consolidation of Variable Interest Entities, has recently enlarged the concept of control to one based on effective control.

These organisations are referred to as keiretsu, as Radebaugh and Gray clarify (i.e., headless combinations). The crucial element in this case is not the legal relationships.

Relationships involving the availability of technology and raw materials, market outlets, sources of debt financing, and intertwined directorships are also crucial.

The secret is group consciousness, which is founded on a system of cooperation built on trust and loyalty amongst people.

As a result, earnings and assets in Japanese consolidated accounts may be significantly overstated, which means they may not be an accurate reflection of group operations.

Many businesses may state that they adhere to U.S. GAAP in order to be listed in the country, although they are not technically comparable to U.S. consolidated accounts.

10.3 The Consolidation's Scope

Consolidated financial statements are a group's financial statements presented as those of a single organisation that includes both the parent and its subsidiaries.

Because some MNCs have a significant number of subsidiaries, preparing consolidated financial statements can be a difficult undertaking. Electrolux AB, a Swedish home appliance company, has roughly 350 active subsidiaries globally.

Unless (1) the subsidiary was acquired with the intention of being disposed of within 12 months and (2) management is actively seeking a buyer, IAS 27 requires a parent to consolidate all subsidiaries, domestic and foreign.

Only when a subsidiary is dormant and its operations are insignificant to the company as a whole may a parent be able to exclude a subsidiary from consolidation.

When a subsidiary is subject to severe, long-term constraints that materially impair its ability to transfer funds to its parent, IAS 27 no longer permits the company to be excluded from consolidation.

Additionally, it prohibits excluding a subsidiary from consolidated financial statements just because its operations differ from those of the other companies that make up the group.

When the parent no longer has control over a subsidiary's financial and operational policies, the subsidiary ceases to be included in the consolidation.

Loss of control by the parent can happen, for instance, when a bankrupt subsidiary is brought under the jurisdiction of a bankruptcy court, when a foreign government assumes control of a foreign subsidiary, or when a contract transfers control to another party.

All subsidiaries must be consolidated under U.S. GAAP unless the parent has lost control due to bankruptcy or severe restrictions put in place by a foreign government.

A subsidiary cannot be excluded from consolidation under U.S. GAAP just because it is being held for sale.

10.4 Full Consolidation

Full consolidation is aggregating 100 percent of a subsidiary's assets, liabilities, revenues, and expenses line by line, even if the group holds less than 100 percent of the subsidiary's equity. The proportion of income and equity in the subsidiary that is not owned by the group is recorded as a separate item in the consolidated financial statements as minority interest. As previously stated, only affiliates controlled by the parent are consolidated. The relevant investment accounts indicate unconsolidated affiliates in the consolidated statements.

The effect that consolidating a subsidiary's financial statements will have on the final consolidated financial statements will depend on how the business combination was handled when the subsidiary was acquired. The acquisition technique is the only one currently permitted to account for company combinations because the pooling of interests approach is forbidden under IFRS 3. We now go over this approach in brief.

Purchase Method

When a firm buys a majority of the voting shares of another company using the purchase method, the assets and liabilities of the acquired company (subsidiary) are revalued to fair value as of the date of acquisition. If the purchase price is greater than the revalued net assets, the difference is referred to as goodwill on acquisition.

Using this strategy, the purchased company only contributes to group profits after the acquisition date.

Initial Carrying Value of Acquired Net Assets

There are two main options for deciding the initial amount at which the subsidiary's assets and liabilities are measured and carried on the consolidated balance sheet when less than 100% of the company is purchased. One method is to calculate the acquired assets and liabilities at book value plus the parent's ownership stake in the difference between fair value and book value on the acquisition date.

Sometimes, this is referred to as the parent company notion.

Consider, for illustration, that Poinsett Company buys 80% of the voting stock of Sumter Company.

Sumter purchased land having a book value of $100,000 and a fair value of $150,000 at the time of acquisition. According to the parent company concept, the land would be valued at $140,000 ($100,000 + 80% [$150,000 $100,000]) on Poinsett Company's consolidated balance sheet at the time of acquisition. This strategy would result in the outside shareholders' investment in Sumter Company being reported as a minority interest on the consolidated balance sheet of Poinsett Company in an amount equal to 20% of the book value of Sumter Company's net assets.

Consider, for illustration, that Poinsett Company buys 80% of the voting stock of Sumter Company.

Sumter purchased land having a book value of $100,000 and a fair value of $150,000 at the time of acquisition. According to the parent company concept, the land would be valued at $140,000 ($100,000 + 80% [$150,000 $100,000]) on Poinsett Company's consolidated balance sheet at the time of acquisition. This strategy would result in the outside shareholders' investment in Sumter Company being reported as a minority interest on the consolidated balance sheet of Poinsett Company in an amount equal to 20% of the book value of Sumter Company's net assets. in an amount equivalent to 20% of the net assets as shown in the book of the Sumter Company.

The alternative method is to first assess the acquired assets and liabilities on the parent's consolidated balance sheet at their fair value at the time of acquisition at 100 percent of their fair value. Under this treatment, also known as the economic unit or entity concept, Sumter Company's land would be valued at $150,000 on Poinsett Company's consolidated balance sheet at the time of acquisition, and the minority interest would be valued at 20% of Sumter Company's net assets.

Both options were acceptable under IAS 22, Business Combinations. IAS 22 is superseded by IFRS 3, Business Combinations, which was published in 2004. The first alternative was eliminated with the publication of IFRS 3. In accordance with the economic unit concept, assets purchased and liabilities assumed in a business combination must now be first measured at their acquisition-date fair value.

In 2008, IFRS 3 was updated, and the purchase method was renamed the acquisition method.

Goodwill

The accounting handling of goodwill varies significantly between nations. Exhibit 9.6's countries mostly demand that goodwill be capitalised as an asset. Japan, however, permits goodwill to be immediately expensed. In the instance of Brazil, goodwill is calculated using the difference between the purchase price and the acquired net assets' book value rather than their fair value.

Most countries require that goodwill be amortised to expense over a set length of time. The maximum number of years that goodwill can be amortised is between 5 and 40. In Canada and the United States, systematic amortisation of goodwill is no longer required. Instead, goodwill must undergo an annual impairment test and be written down when its implied fair value falls below its carrying value.

Goodwill resulting from the use of the acquisition method might be recognised as an asset or, alternatively, could be promptly written off against equity under the original IAS 22, Business Combinations (published in 1983). The prompt write-off of goodwill against equity was removed as a viable option in the 1993 amendment of IAS 22. Goodwill had to be recognised as an asset under IAS 22 (updated 1993) and amortised systematically throughout the course of its useful life, which was estimated to be no more than five years. The useful life of goodwill is presumed to be no longer than 20 years thanks to an update to IAS 22 made in 1998. The systematic amortisation of goodwill during its useful life was outlawed by IFRS 3, which marked a significant change in the regulations. Instead, IFRS now mandates that goodwill be assessed for impairment on a yearly basis, in line with earlier modifications in the United States and Canada.

The excess of the acquirer's stake in the acquiree's net assets over the acquirer's purchase price is frequently referred to as negative goodwill. According to IAS 22, negative goodwill may result from anticipating future losses and expenses; in this instance, the negative goodwill must be postponed and recognised as income when the anticipated future losses and expenses are recognised.

This practise was altered by IFRS 3, which mandated that negative goodwill be recorded as a gain right away in the income statement. As a result, IFRS and North American practise are significantly closer aligned. The distinction is that under IFRS, classifying an item as unusual is not acceptable, whereas under U.S. GAAP, negative goodwill is viewed as an extraordinary gain.

Extraordinary Profit

Sempra Commodities acquired two firms in 2002 for less than the fair worth of the businesses' net assets. According to SFAS 141, "Business Combinations," the disparities were recognised as extraordinary income.

Further Convergence of U.S. GAAP and IFRS

Global capital flows were quickly accelerating at the start of the twenty-first century. When acquirers accounted for purchases in diverse ways, it was impossible to make comparisons. The challenges stemmed from differences between US GAAP and IFRS, as well as inconsistent application of IFRS or US GAAP. As a result, the IASB and FASB embarked on a cooperative endeavour to create a single high-quality accounting standard that would ensure that accounting for company combinations is consistent under both US GAAP and IFRS. To put it another way, the effort aimed to standardise M&A accounting throughout the world's major capital markets.

When the IASB was established in 2001, the FASB had already finalised SFAS 141, Business Combinations, which did away with the pooling of interests technique and substituted a goodwill impairment test for amortisation. In the future, IFRS 3-2004 also required the pooling of interests technique to be replaced with the acquisition method (also known as the purchase method in IFRS 3-2004) to account for company combinations. The cooperative initiative between the FASB and IASB was finished in January 2008 when the IASB released updated versions of IAS 27, Consolidated and Separate Financial Statements, and IFRS 3, Business Combinations.

The revised regulations went into effect on July 1, 2009, with early adoption allowed. In December 2007, the FASB adopted its equivalent standards, SFAS 141(R), Business Combinations, and SFAS 160, Noncontrolling Interests in Consolidated Financial Statements.

The Boards' objective of coming to the same judgements on many significant accounting-related issues relating to corporate combinations was largely met through these statements. The accounting treatment of step and partial acquisitions is one of the major modifications to IFRS as a result of this project. The necessity to measure each asset and liability at fair value at each stage of a staged acquisition (i.e., when an acquirer already owns a portion and buys more shares to take control) has been eliminated. Instead, the acquirer revalues its prior investment in the acquiree at the time it gains control, with any profit or loss being recorded in net income.

The value of goodwill is calculated as the difference, as of the acquisition date, between the net assets purchased and the value of any investments made in the business prior to the acquisition. The remaining (noncontrolling) equity stake in a business combination when the acquirer gains control without purchasing all of the acquiree's stock is assessed at fair value or at the noncontrolling interests' proportional share of the acquiree's net identifiable assets. Before, only the latter was allowed.

The most significant changes to US GAAP are the requirement to adopt the acquisition method for business combinations and the classification of noncontrolling interests as equity.

Furthermore, in-process R&D must be recorded as a separate intangible asset rather than being immediately written off as an expense.

In terms of accounting for company combinations, there are some small variances between US GAAP and IFRS. Noncontrolling interests in an acquiree must be evaluated at fair value under

SFAS 141(R), but IFRS permits noncontrolling equity interests to be measured at fair value or at the noncontrolling interests' proportional share of the acquiree's net identifiable assets.

Additionally, IFRS 3 uses a "reliable measurement" requirement for first recognition, whereas SFAS 141(R) uses a "more likely than not" threshold for noncontractual liabilities.

The comparability of the data about company combinations given in financial reports was improved by SFAS 141(R). SFAS 141(R):

- Offers comprehensive guidance on a range of accounting issues relating to business mergers. It is made very clear that the reporting entity is the entire economic entity produced by the combination, that the consolidated statement of financial position must include a description of all acquired assets and liabilities, and that any minority interest, also known as a "noncontrolling interest," is treated as stockholders' equity.
- The requirement that the cost of an acquisition be allocated to the individual assets bought and liabilities assumed based on their estimated fair values replaces the cost-allocation method in SFAS 141.
- Establishes the acquisition date as the day the acquirer takes control of one or more businesses (SFAS 141 did not define the acquirer but provided direction on identifying the acquirer); the acquirer is defined as the entity that gains control of one or more firms in the business combination.
- requires fair value calculation of the acquiree's noncontrolling shareholding. This will lead to the recognition of goodwill related to the noncontrolling interest in addition to that attributable to the acquirer, which enhances the accuracy and comparability of the resultant information.
- Defines a bargain purchase as one in which the total fair value of the identifiable net assets acquired at the acquisition date is greater than the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and requires the acquirer to recognise the excess in earnings as a gain attributable to the acquirer (SFAS 141 required the "negative goodwill" amount to be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to parti

The pooling of interests approach

It was once permitted in the United States if a number of severe requirements were met. But the FASB released SFAS 141, Business Combinations, in July 2001, which mandates that all business combinations be recorded using the purchase method. Utilization of pooling of interests method is no longer acceptable in America. The pooling approach has also been abandoned in Canada, and it is prohibited in Brazil and Mexico.

In the extremely rare situations when it was difficult to identify an acquirer, IAS 22 permitted the use of the pooling of interests technique. That changed, though, with the publication of IFRS 3 in 2004. All business mergers must be recorded under IFRS 3. The pooling of interests method is no longer permissible under IFRS; instead, use the purchase method.

Equity Method

While many stock investments in other companies do not provide the investor true control over the investee, they do give the investor considerable influence over the investee's operational actions. An organisation that is neither a subsidiary nor a joint venture but in which the investor has a substantial amount of influence is called an associate. The equity method must be used in the majority of nations to account for investments in associates.

Determining significant influence is essential to selecting investments in companies that are affiliates. The accepted practise around the world is to consider ownership of 20% of the voting shares or more as proof of significant influence. The United States and the United Kingdom first approved this arbitrary level in 1971. The Seventh Directive of the European Union then adopted it in 1983. Although the 20 percent ownership criterion for determining significant influence is frequently used, there does not appear to be a compelling case in favour of it.

The consensus over the threshold (20% shareholding) associated to the use of the equity method, on the other hand, according to Nobes, "seems to have arisen by accident." Brazil, Mexico, and Italy all employ a 10 percent criterion; Hungary uses 25 percent (10 percent for banks); while Spain uses 3 percent. Brazil, Mexico, and Italy also differ from the norm in this regard.

A presumption of significant influence is created under IAS 28, Accounting for Investments in Associates, when an investor directly or indirectly owns shares through subsidiaries that account for 20% or more of the investee's voting power. In contrast, when less than 20% of voting shares are held, significant influence is presumed to not exist unless it can be amply proven.

The equity method is often known as a one-line consolidation. The procedure used in applying it to determine the carrying amount of the investment

on the balance sheet is as follows: the investment is

(1) initially recorded at cost;

(2) increased (or decreased) for the investor’s share of the associate’s profi t (or loss)

after the date of acquisition (adjusted to eliminate the profi t or loss on transactions

between the investor and the associate);

(3) reduced for distributions (dividends)

(4) adjusted for changes in the associate's equity not included in income, such as asset revaluations and differences in foreign currency translation; and

(5) reduced for depreciation of the difference between fair value and book value of the investor's share of the associate's depreciable assets at the date of acquisition.

In addition, the investor's portion of the associate's profits (or losses) following the acquisition date is considered income (or loss).

Amounts are adjusted to:

• Eliminate profits or losses on transactions between the investor and the associate to the extent of the investor's ownership interest in the associate; and

• Depreciate the difference between fair value and book value of the investor's share of the associate's depreciable assets.

For the purpose of accounting for investments in associates, IAS 28 mandates the use of the equity method.

Joint Arrangements: IFRS 11 was released in May 2011. A joint arrangement is one in which two or more parties have joint control, and the parties to a joint arrangement are bound by a contractual agreement that grants them joint control. This definition of a joint arrangement is found in IFRS 11. A joint arrangement is either a joint operation or a joint venture, according to IFRS 11. A joint operation is a joint arrangement in which the parties that share control of the arrangement have rights to its assets and are responsible for its obligations.

A joint venture is a cooperative arrangement in which the parties that share ownership of the enterprise have a claim to its net assets. According to IAS 28, Investment in Associates and Joint Ventures, a joint venturer accounts for its interest in a joint venture as an investment using the equity method.

It is evident that IFRS 11 reflects convergence with U.S. GAAP in terms of joint venture accounting.

In the US, investments in associates and joint ventures must be accounted for using the equity method, and these investments must be included in both the consolidated financial statements and any parent company financial statements that are prepared.

Any revaluation of the assets of the foreign investee cannot be reflected in the investment account of a U.S. investor who has a foreign associate that holds assets at revalued values.

Both IFRS and U.S. GAAP call for the investment to be recorded at fair value on the investor's balance sheet when the investor has little to no control over the investee. Additionally suitable for nonconsolidated subsidiaries is the fair value method.

Summary

Large corporations typically have operations in multiple countries. Financial statements of a business having numerous divisions or subsidiaries are called consolidated financial statements. Companies frequently refer to the aggregated reporting of their entire firm together when using the term "consolidated" in financial statement reporting. Consolidated financial statement reporting, on the other hand, is defined by the Financial Accounting Standards Board as the reporting of an entity that is organised with a parent company and subsidiaries. When a corporation reports on a global scale, it must also adhere to the International Financial Reporting Standards set out by the International Accounting Standards Board (IFRS). Companies that elect to publish consolidated financial statements with subsidiaries must adhere to a number of specific rules set forth by both GAAP and IFRS.

Keywords

Control: The authority to direct an entity's financial and operational policies in order to profit from its operations.

Equity interests are widely defined as ownership interests in investor-owned firms as well as owner, member, or participant interests in mutual entities for the purposes of IFRS 3.

Fair value: The sum for which an asset could be traded or a responsibility satisfied between informed, cooperative parties in a transaction conducted at arm's length.

Goodwill is an asset that represents the potential financial gains from other assets acquired through a business merger but not identified and recorded separately.

Non-controlling interest : Equity in a subsidiary that is not directly or indirectly attributable to a parent is known as a noncontrolling interest.

Owners: The term "owners" is used generally in the context of IFRS 3 to refer to individuals who possess equity interests in investor-owned entities as well as individuals who are owners, members, or participants in mutual entities. For annual reporting periods starting on or after January 1, 2011, IFRS 3 is applicable. Application ahead of time is allowed.

Business Combination: a deal or occasion where a buyer takes over management of one or more companies. A business is an integrated group of activities and resources that may be operated and controlled with the goal of giving investors or other owners, members, or participants a direct return on their investment.

Self Assessment

1 …… is often known as a one-line consolidation.

A. Equity Method
B. Polling of interest method
C. Purchase method
D. Book Value method

2. IFRS….. Joint Arrangements, was issued in May 2011

A. 10
B. 11
C. 12
D. 13

3. Which of the following is wrong about Equity Method?

A. The equity method is often known as a one-line consolidation

B. the investor's share of the associate's profi t (or loss) after the date of acquisition is treated as income (or loss).

C. IAS 28 requires use of the equity method in accounting for investments in associates.

D. In the United States, the equity method is not required for investments in both associates and joint venture.

4. Which of the following is wrong about Pooling of Interests Method?

A. Use of the pooling of interests method is no longer permitted in the United States.

B. The pooling method also has been eliminated in Canada and is not allowed in Brazil and Mexico.

C. IAS 22 allowed the use of the pooling of interests method in those rare cases where it was impossible to identify an acquirer.

D. IFRS 3 requires all business combinations to be accounted for using the pooling of interests method.

5. The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities is called:

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Fair Value

6. For the purpose of IFRS 3, ….. is used broadly to mean ownership interests of investor-owned entities, and owner, member, or participant interests of mutual entities

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Fair Value

7. The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction is called:

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Fair Value

8. An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized is called…

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Goodwill

9. The equity in a subsidiary not attributable, directly or indirectly, to a parent.

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Goodwill

10. For the purpose of IFRS 3, the term "……" is used broadly to include holders of equity interests of investor-owned entities, and owners, members of, or participants in mutual entities

A. Fair value

B. A business

C. A business combination

D. Owners

11. : A transaction or event in which an acquirer obtains control of one or more businesses.

A. Fair value

B. A business

C. A business combination

D. Owners

12. An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members, or participants

A. Fair value

B. A business

C. A business combination

D. Owners

13. SFAS ……. improved the comparability of the information about business combinations provided in fi nancial reports.

A. 141(R)

B. 142R

C. 143R

D. 145R

14. IFRS allows …….. to be measured either at fair value or at the non-controlling interests' proportionate share of the acquiree's net identifiable assets.

A. Control

B. Equity Interest

C. Non-Controlling Interest

D. Goodwill

15. …..requires negative goodwill to be recognized immediately in the income statement as a gain

A. IAS22

B. IFRS 3

C. IAS23

D. IFRS4

Answers for Self Assessment

l.	A	2.	C	3.	D	4.	D	5.	A
6.	B	7.	D	8.	D	9.	C	10.	D
11.	C	12.	B	13.	A	14.	C	15.	B

Review Questions

1) Describe a group. Compare and contrast a group's various concepts.
2) What particular kind of business combination does the concept of a group relate to?
3) Define control. When does control, as defined by IAS 27, exist?
4) Describe why, in some nations, like Japan, the legal idea of control might be appropriate.
5) What conditions could, and perhaps should, prevent a subsidiary from being consolidated?

Further Readings

- International Accounting By Das Mahopatra, Prentice Hall
- International Accounting By Rathore, Shirin, Prentice Hall
- International Financial Management By Jeff Madura
- International Accounting, By Timothy S Doupnik; Hector Perera,Publisher: Mcgraw-Hill Education, Year: 2014, Isbn: 0077862201,9780077862206

Unit 11: International Taxation

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the concept of International Taxation Policy and its application in actual practice.
- explain the concept of income of a company, corporate tax and double taxation,
- discuss methods to obtain relief for double taxation.

Introduction

Taxes have a significant bearing on business decisions ranging from designing a suitable capital structure, managing foreign exchange risk, determining the cost of financing, deciding mode and destination of foreign investments, to determine transfer prices and manage inter affiliated fund flows. Process of computation of taxable income and corresponding taxes vary across nations depending on what 'costs' are deductible from the revenues. Process of computation of taxable income and corresponding taxes vary across nations depending on what 'costs' are deductible from the revenues. Also, the Tax rates vary from country to country and from time to time. Puerto Rico stands in the first position in the world for the highest corporate tax of 39% in 2021, followed by Suriname with a 36% rate. Zambia, Argentina, Sudan, Guinea, Guam, Congo, Chad, Malta, and Equatorial Guinea have 35% corporate tax rate. While, Belgium, Venezuela, and Brazil have 34% rate whereas Colombia, Cameroon, and Seychelles have 33% rate. Gambia, and Morocco have 32% and Mozambique and Namibia have 31%. In Japan, the Corporate Tax is 30.86% while there are countries like Angola, Australia, Costa Rica, El Salvador, Ethiopia, and Gabon. Germany, Kenya, Malawi, Mexico, Nicaragua, Nigeria, Papua New Guinea, Philippines, Republic of the Congo, Rwanda, Senegal, Sierra Leone, Tanzania, and Uganda with 30% corporate tax. Fifteen countries do not have a general corporate income tax. Those countries are Anguilla, the Bahamas, Bahrain, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Isle of Man. International tax planning, also known as International tax structures, is one element of International taxation that was created to implement the guidelines of various tax authorities following the global recession of 2008.

11.1 International Tax Planning

- It allows minimizing the tax burden associated with operations done from and to other territories through the Tax Treaties as well as multilateral agreements (Direct Tax European Union Directives and VAT Directives) stands out and becomes very useful.
- Applying these rules together with the internal Law could achieve a significant tax burden reduction that affects every business or specific transaction. These include the avoidance of double taxation and the use of reduced taxation.
- This means increased cash flows that can be used to develop your business and lay the foundation for future activities.
- In other words, International tax planning supports your organization's business objectives. Through this process, profits remain within your organization, not transferred through taxation.
- Good planning can also lead to the development of a comprehensive strategy that is used to assess and use international opportunities as they arise.

11.2 Objectives of International Taxation

1. Tax Neutrality
2. Tax Equity

1. Tax Neutrality

- A concept that the structure of a fund does not lead to a duplicative layer of taxes borne by investors.
- In particular, the jurisdiction where it is established should not impose taxes on its income and capital gains.

Forms of Tax Neutrality

I. Domestic Neutrality
II. Foreign Neutrality

Domestic Neutrality

- When tax laws do not affect capital owners' choice between investing in their home country or host country.
- "Taxation is export neutral if domestic and overseas investments that earn the same pre-tax rates of return also yield same after tax rate of returns…………..
- If capital export neutrality is violated, the capital owner will have an incentive to invest more where the tax is lower, thereby realizing a higher after-tax rate of return."

Foreign Neutrality

- When tax laws do not distort after- tax earnings to domestic and foreign investors, it is known as Foreign Neutrality.
- "Taxation is import neutral if equal before tax returns to competing supplies of capital translate to invest more where tax rate is lower, thereby realizing a higher after tax rate of return."

In any given situation, it is either export neutrality or import neutrality that holds good, and not both.

A perfect neutral tax system will mean all countries have the same tax rates and that no double taxation occurs; a proposition almost impossible to achieve.

Import neutrality wherein they currently tax foreign branch profits but defer taxing the earnings from foreign subsidiaries till they are repatriated.

That's' why major capital exporting countries like Unites States, Japan, Germany, Sweden, and Great Britain have a mixed policy of capital export and Other countries like the Netherlands, France, Canada, and Hong Kong fully exempt foreign incomes from domestic taxation, and Italy, Switzerland, and Belgium exclude a part of foreign income from the computation of domestic tax liability.

2. Tax Equity

- A system of taxation where equal sacrifices are made by taxpayers in bearing the tax burdens is known as Tax Equity.
- The basic difference between tax neutrality and tax equity lies in the fact that the former is achieved by ensuring that investment decisions are unaffected due to difference in tax laws, the latter is achieved by ensuring that equal sacrifices are made in bearing the tax burden under similar circumstances.
- Tax equity favors the imposition of corporate income tax in the same manner and rates regardless of whether the income is generated through a foreign branch or a domestic branch.
- The rationale behind tax equity is to ensure that all similarly situated taxpayers must bear the cost of running a government.

Meaning of Corporate Tax

- A corporate tax is a tax on the profits of a corporation. The taxes are paid on a company's taxable income, which includes revenue minus cost of goods sold (COGS), general and administrative (G&A) expenses, selling and marketing, research and development, depreciation, and other operating costs and tax loopholes, and so the effective corporate tax rate, the rate a corporation actually pays, is usually lower than the statutory rate; the stated rate before any deductions.
- Corporate tax rates vary widely by country, with some countries considered to be tax havens due to their low rates. Corporate taxes can be lowered by various deductions, government subsidies,

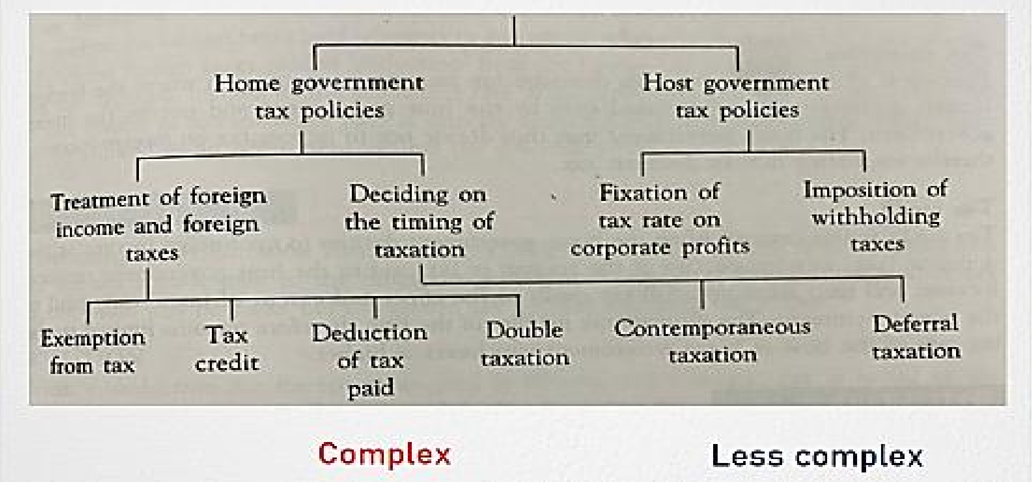
How Would You Calculate Your Corporate Tax?

- Based on your business type, you need to pay the corporate tax according to the tax slabs implemented by Income Tax Department. It can be different from one company to another because a business entity can earn from different resources

- and have to calculate their taxes based on their earning resources only. Here, you can find some basics that can help you to calculate your corporate taxes:
- The Finance Ministry of India has announced a new tax slab where companies or business entities having turnover up to 400cr have to pay 22% corporate tax along with other taxes such as surcharge and cess.
- So, if you use the Corporate Tax Calculator for financial numbers, you can find this slab with 25.17% tax. It means you need to pay 25.17% tax on your income if you have income from your company less than 400cr.
- But you can apply for some redemptions and incentives under sections 15BA, 15BAA, and 15BAB. You do not need to pay MAT or minimum alternate tax in this case.
- The Indian Government has an initiative, "Make in India", designed to boost new businesses, especially manufacturing industries, to start their business in India.
- For new firms, Finance Ministry has some tax relaxations, and domestic companies that started their business in India after 1st October 2019 can pay 15% corporate tax on their income.
- But, you can file your corporate tax under this act if you do not apply for any incentives before 31st March 2023.
- For example, if you apply for the incentives before 2023, you have to pay 107.01% corporate tax instead of 15%. But there is no additional surcharge or cess applicable for new firms.
- Naturally, Indian firms can benefit more from foreign companies. The Finance Ministry of India has implemented different laws for foreign companies, depending on the company's location.
- There are two different tax slabs that any foreign company can follow. If a foreign company receives any technical assistance from an Indian firm and has made an agreement before 1st April 1976, then the company has to pay a corporate tax of 50%.
- If the income is more than 10cr, the company has to pay a 5% surcharge and corporate taxes.
- Still, the company's agreement should be registered under the Government of India. Foreign companies with other income sources have to pay an additional 40% corporate tax along with a 2% surcharge.

11.3 International Taxation Policy in Actual Practice

The popular tax policies at home and in host countries may be outlined in the figure given in the next section



11.4 Home Country Taxation Policy

There are 2 dimensions of it:

1. Treatment of Foreign Income and Foreign Taxes paid
2. Timing of Taxation

Treatment of Foreign Income and Foreign Taxes paid

Four ways in which a host government can treat foreign income earned and taxes paid	
Exemption of foreign income from domestic tax	Granting full tax credit for foreign taxes paid
Giving deductions for foreign taxes paid	Taxing foreign income by completely ignoring foreign taxes already paid on income (Double Taxation)

Tax Exemption

- Exemption of foreign income from the domestic tax amounts to a situation where foreign income accrued to a firm is taxed only by the host government and not by the home country.
- Home government may thus decide not to impose tax on foreign income, thereby exempting it from domestic tax.

Tax Credit

- The system emerges when the home government decides to tax foreign income at the domestic rate irrespective of the amount of tax paid to the host government on such income; and then allowing a full tax credit to the effect and extent of tax already paid to the host government.
- Ultimate tax liability of the firm, therefore, remains limited to the tax rate of the host or home government whichever is higher.
- Assume a company named 'Harvest Pvt. Ltd.' generates a gross turnover of SGD 35,00,000 (INR 201,122,600) and is to pay the corporate tax of 16.50% in Singapore and in India as 34.5%. Indian Government decides to a) Exempt Foreign Income accrued to its Firm and b) allows full credit in respect of Foreign taxes already paid.

Finding out Tax Liability and After Tax Income of Harvest Pvt. Ltd. for the FY 22-23.

	Tax Liability and After Tax Exemption	Tax Income in case Tax Credit is given
Foreign Income	SGD 35,00,000	SGD 35,00,000
Less Foreign tax paid to Singapore Government @	SGD 5,73,750.00	SGD 573,750.00

16.50%		
Income after Singapore Government levies the Corporate Tax	SGD 29,26,250	SGD 29,26,250
Less: Indian Corporate Tax @ 34.5%	NIL	SGD 12,07,500 - SGD 5,73,750.00 = SGD 6,30,000
Net Income After Tax	SGD 29,26,250	SGD 16,66,250

Tax Deduction

- Deduction of foreign taxes paid leads to a situation where the home country government allows foreign taxes paid as a deduction from foreign income and then imposes a tax on reduced income at the prevailing rate of domestic tax.
- Continuing with the same example. Assume the Indian Government decides to give a deduction for tax already paid to the Singapore Government instead of tax exemption or tax credit. What will be the Tax Liability and After-Tax Income of Harvest Pvt. Ltd.?
- Income after Singapore Government levies the Corporate Tax = SGD 29,26,250
- Indian Corporate Tax @ 34.5%
- Amount of Corporate Tax in India = SGD 6,30,000
- Income after Domestic Corporate Tax = SGD 16,66,250

Live Example of HUL

Source: https://www.hul.co.in/files/dae4061d-1db5-46b1-b493-909c2f31255a/tax-transparency-report-ybnfsw.pdf

Subjected to taxation in India and Nepal.

Tax legislation in these countries differs, is often complex and subject to interpretation by management and the government authorities.

Recent developments in the international tax arena have increased the likelihood of changes to tax systems in the countries where it operate, and which creates added uncertainty.

It continue to engage with the tax authorities and promote open, transparent working relationships.

Basis of Preparation at HUL

- The amounts reported under 'Total Tax Contribution' are for the period 1 April 2021 to 31 March 2022
- The information has been reported at a country level by relying upon the tax payments made during the aforesaid period by entities in scope
- The tax contribution in Nepal jurisdiction has been converted from NPR to INR using an average FX of NPR 0.63/INR

Summary of HUL's Total Tax Contribution for FY 2021-22:

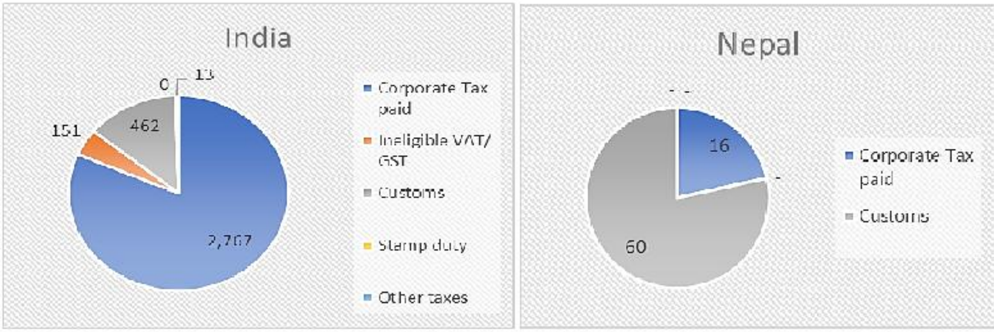
INR Crores

Sr. No.	Country	Total Taxes borne	Total Taxes collected	Total Taxes contributed
1.	India	3394	4930	8324
2.	Nepal	76	46	122
	Total	**3470**	**4976**	**8446**

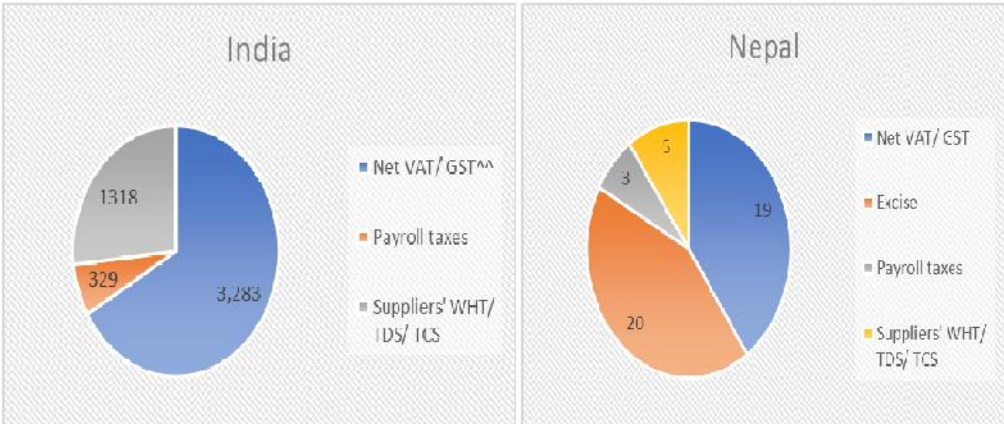
Tax Contribution of HUL

- Taxes borne are the company's own contribution in taxes that impact their results, e.g., corporate taxes computed as a basis of taxable income
- Taxes collected are those administered by the company on behalf of the government and collected from others, e.g., tax deduction at source from
- employees' salary and in-turn deposited with the government
- GST/ VAT: Goods and Service Tax (GST)/ Value Added Tax (VAT) is a consumption tax that is levied on the added value.
- GST/ VAT represents the tax billed by us to the customers which were collected by us from customers and eventually, paid to the respective jurisdictional governments.
- It also incurs VAT/ GST when purchasing certain goods and services. In the countries where we operate, the VAT/ GST collected are offset against the VAT/ GST incurred with the net being paid to the government.
- We have shown the net GST/ VAT discharged by us during the period after the utilization of VAT credit/ Input tax credit
- Tax withheld on behalf of suppliers: These represent taxes withheld by us on vendor bill payments and paid to the government on behalf of such vendors
- Taxes collected at source: These represent taxes collected by us from our customers on specified transactions and paid to the government on behalf of such vendors
- Payroll Taxes: Payroll Taxes represent taxes withheld on salary payments to individuals employed with us and paid to the governments on their behalf.
- Others: Includes taxes collected at source and any other taxes collected on behalf of others and paid to the government

Breakup of Taxes Borne:



Breakup of Taxes collected:



^^ Output GST collected - INR 17346 Crores net off Input Tax Credit – INR 14063 Crores

Source:https://www.hul.co.in/files/dae4061d-1db5-46b1-b493-909c2f31255a/tax-transparency-report-ybnfsw.pdf

The Output GST collected for HUL is INR 17346 Crores and net off Input Tax Credit being INR 14063 Crores

Other Financial Information of HUL

		INR Crores				
Tax jurisdiction	Nature of activities in country	Average Employees	Revenue	Profit before Tax	Corporate tax accrued	Profit after tax
India	Manufacturing and sale of fast-moving consumer goods, saloon business, others	20593	52005	11794	2969	8825
Nepal	Manufacturing and sale of fast-moving consumer goods	239	441	83	16	67
Total		**20823**	**52446**	**11877**	**2985**	**8892**

Source: https://www.hul.co.in/files/dae4061d-1db5-46b1-b493-909c2f31255a/tax-transparency-report-ybnfsw.pdf

Double Taxation

- A situation where an income is subject to tax twice. This can occur in one of two ways - economic or juridical.
- Economic double taxation occurs if an income or a part of it is taxed twice in the same country, in the hands of two individuals.
- Alternatively, juridical double taxation occurs if income earned outside India is taxed two times in the hands of the same individual, once abroad and once in their home country.
- This unique situation puts an undue burden on the taxpayer when their income is taxed twice.
- Double taxation is usually an issue for NRI's and Foreign Nationals doing business in India.
- Therefore, the double tax liability of an assessee is mitigated by countries through tax treaties between countries.

2nd Dimension of Home Country Tax Policy - Timing of Taxation

Its' the second most important dimension of a home government's foreign tax policy. In practice, there are two choices available to the government of any country.

Timing of Taxation

Choice 1: Taxing Foreign Income in same fiscal year in which it is earned (Contemporaneous Taxation), and;

Choice 2: Taxing only when incomes are repatriated (Tax Deferral)

Example of Timing of Taxation

In the United States, Tax Incomes of Foreign Branches under the Contemporaneous Taxation System are followed, whereas incomes from foreign subsidiaries follow tax deferral system.

Thus, Branches are considered to have no separate legal existence from parents and have foreign income generated through branches traced by most countries like the USA in the same year in which they are earned.

11.5 Corporate Tax Rate (Excluding Surcharge and Cess) on Domestic Company

- Turnover or Gross Receipt in previous year 2018-19 not exceeding 400 crores :25%
- If opted for Section 115BA : 25%
- If opted for Section 115BAA: 2%
- If opted for Section 115BAB: 15%
- Any other Domestic Company: 30%

Surcharge on Domestic Company

Surcharge is an additional charge levied for persons earning income above the specified limits, it is charged on the amount of income tax calculated as per applicable rates in next slide.

If the Taxable income above 1 crore– Up to 10 crore: 7%

If Taxable income above 10 crore: 12%

If Company opting for taxability u/s 115BAA or Section 115BAB: 10%

Health and Education Cess on Domestic Company

Health and Education cess @ 4% shall also be paid on the amount of income tax plus surcharge (if any).

Corporate Tax on Foreign Company

As per Section 2(23A) Foreign Company means a company which is not a Domestic Company.

Royalty from Government or an Indian concern in pursuance of an agreement made with the Indian concern after 31st March 1961, but before 1st April 1976, or fees for rendering technical services in pursuance of an agreement made after 29th February 1964 but before 1st April 1976 and where such agreement has, in either case, been approved by the Central Government: 50%

Any other income: 40%

Surcharge on Foreign Company

Taxable income above 1 crore - Up to 10 crore: 2%

Taxable above 10 crore: 5%

Health and Education Cess

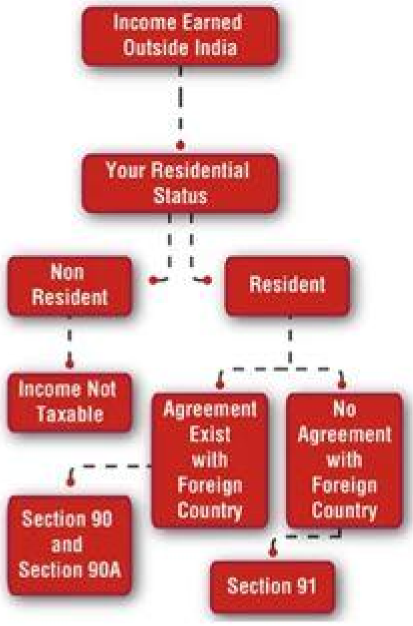
Health and Education cess @ 4% shall also be paid on the amount of income tax plus surcharge (if any).

Double Taxation

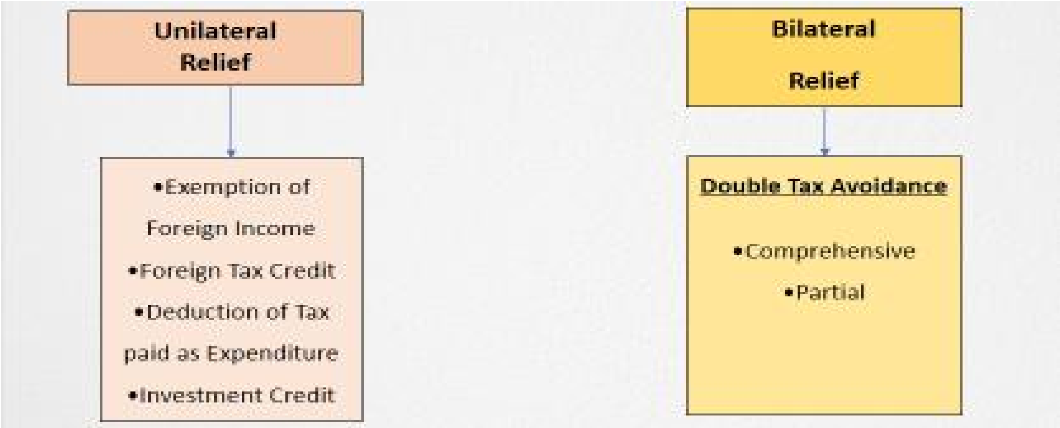
- A situation where an income is subject to tax twice. This can occur in one of two ways - economic or juridical.
- Corporate Double Taxation - This refers to the taxation on corporate profits through corporate taxation and dividend taxation (imposed on dividend pay-outs).
- International Double Taxation - This refers to the taxation of foreign income in both the country where the income is derived and the country where the investor resides.

11.6 Double Taxation Avoidance Agreement

- DTAA is an effective financial agreement that is beneficial to both the taxpayer as well as the respective tax collection authorities in various countries.
- It is a tax treaty that India signs with another country in order to avoid double taxation. Using this treaty, an individual can avoid being taxed twice.
- DTAAs can either be comprehensive agreements, which cover all types of income, or specific agreements, which target only certain types of income.
- For instance, there is a DTTA (Double Taxation Avoidance Agreement) between India and Singapore under which income is taxed based on the residential status of the individual.
- This streamlines the flow of taxation and ensures that the individual is not taxed twice for the income earned outside India. Currently, India has DTAAs in place with more than 80 countries.
- Indias' Double Tax Avoidance Treaty
- India has Double Tax Avoidance Treaty (DTAT) with 88 countries out of which 86 are in force. For transactions involving persons having interest between countries with which India has a DTAA, there are agreed rates of tax and jurisdiction on specified types of income.
- Many people believe that the DTAA will allow them to avoid paying taxes altogether, but that is not true. Since the DTAA allows for a rebate, not a total deduction, NRIs can decrease their tax implications when they earn income in India.
- India has Double Taxation Avoidance Agreements (DTAA) with 84 countries. In this article, we look at the Double Taxation Treaty and Double Taxation Avoidance Agreements in detail.
- Therefore, through Section 90, tax relief is provided for those person residents of a country with which India has signed DTAA.



11.7 Double Taxation Relief



Unilateral Relief

- Relief measure taken by one country alone.
- It is in the interest of developing countries like India, to induce its residents to earn as much as possible in foreign exchange and also to import foreign capital and suitable technology for Industrial development, their tax structure generally contains a provision for relief against the burden of double taxation.

Forms of Unilateral Relief

a. Exemption of Foreign Income
b. Foreign Tax Credit
c. Deduction of Tax paid abroad as Exepnditure
d. Investment Credit

Exemption of Foreign Income

- Income may be exempted from taxation either by the domestic country or the country at source.
- It is provided in case of income of permanent establishments, income from real estate situated abroad and on foreign dividend received by domestic company.
- Foreign Tax Credit
- Permits Tax Payers to credit the tax paid in one country against the tax liability in home country.
- If rate of tax is higher in domestic country as compared to country of source income, tax payer would be required to pay the difference in domestic country.
- No refund is generally given to the tax payer if the tax rate is higher in source country than in domestic country.

Rules for Claiming the Foreign Tax Credit

Rules for claiming the foreign tax credit are notified under Rule 128 of Income Tax Rules.

Certain significant rules are enumerated below:

- The foreign tax credit shall be claimed by an Indian resident only if he has paid any tax in a foreign country or specified territory outside India. Such credit can be claimed in the year in which the income corresponding to such tax has been assessed to tax or offered to tax in India. However, if such income is offered/assessed to tax in more than one year, then foreign tax credit can be claimed across those years in proportion to the income offered/ assessed to tax in India;
- The foreign tax credit shall be available only against the amount of tax (including tax paid as per MAT/AMT), surcharge, cess payable under the Indian tax laws and not against interest, penalty or fee;
- The foreign tax credit shall not be available on the foreign tax, which the taxpayer disputes. Such tax credit shall be available only after the dispute is settled if the taxpayer provides the certain evidences within 6 months from the end of the month in which the dispute was finally settled.
- The evidences includes proof for the settlement of dispute, payment of the disputed tax, a declaration that no refund of such amount is claimed or will be claimed whether directly or indirectly.
- Documents required to be provided for claiming the foreign tax credit.
- For claiming the foreign tax credit, the taxpayer shall be required to a statement in Form No. 67 and a certificate or statement indicating the nature of income and the amount of tax deducted or paid by the taxpayer……..
    a) from the tax authority of foreign nation; or
    b) from the person who is responsible for deduction of such tax; or
    c) a statement signed by the taxpayer accompanied by the following documents:

    - where tax has been paid: an acknowledgement or challan for online payment or bank counterfoil

    - where the tax has been deducted: proof of deduction.

    d) Such documents shall be furnished on or before the due date of filing income tax return as per section 139(1) of the Income Tax Act.

Deduction of Tax Paid Abroad as an Expenditure

- Minor relief is provided to tax payer under this method.
- Tax payer is only allowed to treat the tax paid in a foreign country as an expenditure and deduct it from total income arising in a foreign country of primary residence.

Investment Credit

This method allows a percentage of capital invested abroad to be deducted from income in the country of residence. This % age depends upon expected rate of return on capital in that country.

Unilateral Relief Provisions in India Where no Double Tax Avoidance Treaty Exists

- The details of the same are discussed under section 90 of Income Tax Act. Relief under this section may be claimed by an Indian resident only if there is no ……….
- DTAA with the other country from where you have earned income. Such relief is given voluntarily by India in case of unilateral agreements.
- The foreign tax credit shall be computed separately for each source of income.
- It shall be computed as lower of:
- Tax payable on such income under the Income Tax Act and

- Foreign tax paid
- The foreign tax credit shall be determined by conversion of the foreign currency at the Telegraphic Transfer Buying Rate (TTBR) of the last day of the month immediately preceding the month in which the foreign tax has been paid or deducted.
- Note: Foreign tax credit shall be the total of credit computed separately for each source of income arising from a particular country.

11.8 Computing Double Taxation Relief Under Section 90

Step 1: Compute Global Income, i.e. aggregate of Indian income and Foreign income;

Step 2: Compute tax on such global income under Income tax;

Step 3: Compute average rate of tax (amount of tax divided by global income);

Step 4: Compute an amount by multiplying such average rate of tax with foreign income;

Step 5: Compute tax paid in a foreign country

The amount of relief shall be lower of step 4 and step 5

Case Analysis: Mr A, an Indian resident, earned income in India INR 2,00,000. He also earned income from the USA equivalent to INR 3,00,000 (Tax paid in foreign country INR 20,000). What tax relief Mr A can claim, and the tax he shall be required to pay?

Step 1: Global income is INR 5,00,000 (INR 2,00,000 + INR 3,00,000)

Step 2: Tax on global income INR 12,500

Step 3: Average rate of tax INR 2.5% (12,500/5,00,000*100)

Step 4: Tax required to be paid INR 7,500 (3,00,000*2.5/100)

Step 5: Tax paid in foreign country is INR 20,000

The amount of relief shall be lower of step 4 and step 5, i.e. INR 7,500

Conditions for Claiming Relief Under Section 90

- The tax payer should be a resident in India during the previous year
- The Income should have accrued outside India
- Tax payer should have already paid the tax on income in another country as a deduction or otherwise
- Income is taxable in India and no double taxation avoidance treaty exists with that country

11.9 Foreign Income of a Resident Under Section 91

The section provides for relief in case of income accruing to a taxpayer in any country with which India has not so far entered into an agreement and tax payer is subjected to tax in both countries on same income.

Agriculture Income From Pakistan Derived by a Resident

Agriculture Income from Pakistan is to be included in total income of resident tax payer for Indian tax purpose.

As the tax is already paid in Pakistan, he gets a relief under sub section (2) of section 91 of Income Tax.

Share of Non-Resident Partner in Foreign Income of Resident Registered Firm

Relief is granted to a non-resident partner of a registered firm resident in India, in respect of its Foreign Income, provided:

- Tax payer is non-resident in India in previous year
- Tax payer is assessed on his/her share in the income of a resident firm
- Such share income includes any income accruing outside India
- The income so included is taxed both in India and in a foreign country with which India has no DTA agreement
- Tax payer has paid the tax on the income in such foreign country

Computing Relief Under Section 91

Step 1: Calculate the tax payable in India

Step 2: Compare the Indian tax rate and foreign tax rate

Step 3: Multiply the lower tax rate with the doubly taxed income. This will be the amount of relief under section 91.

Case Analysis: MrSubba Rao has doubly taxed foreign income of INR 2,00,000. Tax payable in India is at the rate of 30%. The foreign tax rate is 20%. What amount of relief can he get?

Step 1: Tax payable in India will be INR 60,000 (2,00,000 X 30%)

Step 2: Lower of Indian rate of tax (30%) and foreign tax rate (20%) is 20%.

Step 3: The relief will be INR 40,000 (2,00,000 X 20%)

The amount of relief will be as computed in Step 3, i.e. INR 40,000.

Bilateral Relief Methods

A. Exemption Method

The exemption method ensures that you will not be taxed twice. That is, if an income earned outside India has been taxed in the relevant foreign country, it is not subject to tax in India.

B. Tax Credit Method

According to this method, the individual or the corporation can claim a tax credit (deduction) for the taxes paid outside India.

This tax credit can be utilized to set-off the tax payable in India, thereby reducing the assessee's overall tax liability.

Double Taxation Relief Example - Tax Credit Method

Example: As per the DTAA between India and Germany, interest is taxed at 10%, whereas under Income Tax Act 1961, it is based on slab rates for individuals and HUFs, and flat rates (generally 30%) for other despite the fact that there are few things an individual taxpayer can do to avoid double taxation, the Income Tax Act itself contains provisions for individuals whose income is likely to be taxed twice. Double Taxation Avoidance Agreements (DTAAs) are the basis for this relief measure.

Double Taxation Relief - Unilateral Relief Covered Under Section 91

Section 91 of the Income Tax Act, 1961 provides for unilateral relief against double taxation. According to the provisions of this section, an individual can be relieved of being taxed twice by the government, irrespective of whether there is a DTAA between India and the foreign country in question or not.

However, there are certain conditions that have to be satisfied in order for an individual to be eligible for unilateral relief. These conditions are:

- The individual or corporation should have been a resident of India in the previous year.
- The income should have been accrued to the taxpayer and received by them outside India in the previous year.
- The income should have been taxed both in India and in the country with which there is no DTAA.
- The individual or corporation should have paid tax in that foreign country.
- Thus, by utilizing the provisions of DTAAs and the relief measures offered under the Income Tax Act, individuals earning income from other countries can minimize their tax liabilities and avoid the burden of double taxation.

Benefits Available Under DTAAs

- The basic benefit includes not having to pay double taxes on the same income.
- According to these treaties, each country determines its own resident status in accordance with its domestic laws. When a person qualifies for tax residency in both countries, the treaty may provide a tiebreaker.
- As an example, a PIO could qualify as an Indian tax resident if his/her stay in India exceeds a specific threshold. Additionally, they may be considered US tax residents by virtue of their citizenship.
- In this case, the tiebreak rule under the India-USA DTAA comes into play, and it may occur that the person qualifies as a tax resident of the United States.
- Those who are tax residents of countries with which India has DTAAs can claim tax exemptions under these agreements and their tax liability in India will be limited to the extent of taxing rights permitted by the DTAAs.
- Even if the scope of taxation under the Indian income tax law is wider, such individuals may benefit from the treaty by virtue of section 90 of the Indian Income-tax Act, 1961, subject to certain procedural requirements, such as submission of Tax Residency Certificates (TRC) of the other country.
- However, if a person qualifies as a tax resident of India both under the Indian law and the relevant treaty, then India will have residual powers of taxation, subject to the limited rights granted to the other country under the treaty.
- Foreign Tax Credit (FTC) in India - Once an NRI or PIO qualifies as an Indian tax resident, he/she will be eligible to claim credit of taxes paid in other foreign countries in his/her income tax return filed in India, subject to certain conditions and procedural compliances prescribed in rule 128 of the Income Tax Rules.
- FTC is allowed in the year when the corresponding income is taxed in India. Form 67 along with documents supporting payment or deduction of tax in other countries will be required to be submitted by the individual.
- To claim FTC, one needs to provide a certificate or statement that specifies the nature of income and the amount of tax deducted from or paid by the assessee.
- You can obtain one of the following:
    - From the tax authority of the country or the specified territory outside India; or
    - From the person responsible for deduction of such tax; or signed by the assessee (along with an acknowledgement of online payment or bank counterfoil of challan for payment of tax where the payment has been made by the assessee or proof of deduction where the tax has been deducted).

- It may be noted that FTC is allowed only in respect of taxes paid in other countries in accordance with the applicable DTAA and any excess foreign tax will be ignored. Also, FTC will be limited to the extent of taxes payable in India.

Summary

The impact of taxation is one of the key factors for any trade and investment choice in other nations in the current era of cross-border activities throughout the globe. The obvious effect of one country's domestic tax laws on the economy of another country is one of the most important effects of globalisation. This has made it necessary to continually evaluate the tax systems of various nations and implement the required reforms.It is possible to be subjected to double taxation when a taxpayer resides in one nation but derives income from a different nation. This results from the two fundamental rules—i) the source rule and ii) the residence rule—that allow both the nation of resident and the country where the source of income exists to levy tax. The residence rule states that the country where the taxpayer resides should have the authority to levy taxes, as opposed to the source rule, which states that income must be taxed in the country where it originates regardless of whether it is received by a resident or a non-resident.The expense of conducting business internationally would become prohibitive and the progress of globalisation would be hindered if both laws were to be applied to a corporate entity concurrently and it were to be subject to tax at both ends. Double Taxation Avoidance Agreements (DTAA) assume a key role from this perspective.

Keywords

Domestic Company: As per Section 2(22A), Domestic Company means an Indian Company, or any other Company which, in respect of its income liable to tax under this Act, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income.

Residential Status of an Entity:

A company is treated as a resident of India in any previous year if:

- it is an Indian company, or
- its POEM in that year is in India

POEM: Refers to a place where the key management and commercial decisions necessary for conducting a company's business activities are made. Since the residential status of any entity is to be determined every year, POEM is also required to be determined yearly.

Self Assessment

1. Corporate Tax Rate % (Excluding Surcharge and Cess) on Domestic Company If opted for Section 115BA

A. 25

B. 30

C. 35

D. 40

2. Corporate Tax Rate % (Excluding Surcharge and Cess) on Domestic Company If opted for Section 115BAB

A. 15

B. 30

C. 35

D. 40

3. Corporate Tax Rate % (Excluding Surcharge and Cess) on Domestic Company If opted for Section 115BAA

A. 22

B. 30

C. 35

D. 40

4. Surcharge on Domestic Company(%)If the Taxable income above 1 crore– Up to 10 crore

A. 7

B. 10

C. 12

D. 15

5. Surcharge on Domestic Company(%)If Taxable income above 10 crore

A. 7

B. 10

C. 12

D. 15

6. Surcharge on Domestic Company(%) If Company opting for taxability u/s 115BAA or Section 115BAB

A. 7

B. 10

C. 12

D. 15

7. Health and Education Cess on Domestic Company(%)

A. 4

B. 5

C. 6

D. 7

8. Corporate Tax on Foreign Company

A. 10

B. 20

C. 30

D. 40

9. Surcharge on Foreign Company(%)Taxable income above 1 crore - Up to 10 crore

A. 1

B. 2

C. 3

D. 4

10. Surcharge on Foreign Company(%)Taxable income above 10 crore

A. 1

B. 2

C. 3

D. 5

11. In case of double tax avoidance reliefs Section……is applicable when agreement exists with foreign company.

A. 90

B. 91

C. 92

D. 93

12. In case of double tax avoidance reliefs Section……is applicable when no agreement exists with foreign company.

A. 90

B. 91

C. 92

D. 93

13. In case of Agriculture Income From Pakistan Derived by a Resident As the tax is already paid in Pakistan, he gets a relief under sub section (2) of section:

A. 90

B. 91

C. 92

D. 93

14. As per the DTAA between India and Germany, interest is taxed at ………%, whereas under Income Tax Act 1961, it is based on slab rates for individuals and HUFs, and flat rates (generally 30%)

A. 10

B. 35

C. 40

D. 45

15. Double Taxation Relief - Unilateral Relief Covered under Section 91: which of following is not pre requisite?

A. The individual or corporation should have been a resident of India in the year preceding the previous year.

B. The income should have been accrued to the taxpayer and received by them outside India in the previous year.

C. The income should have been taxed both in India and in the country with which there is no DTAA.

D. The individual or corporation should have paid tax in that foreign country.

Answers for Self Assessment

l.	A	2.	A	3.	A	4.	A	5.	C
6.	B	7.	A	8.	D	9.	B	10.	D
11.	A	12.	B	13.	B	14.	A	15.	A

Review Questions

1) What methods are available for avoiding double taxation?
2) Explain applicability of unilateral relief.
3) Explain applicability of Bilateral Relief.
4) Explain the factors leading to Double Taxation/
5) How Double Taxation Relief is computed Under Section 90?

Further Readings

- https://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx
- https://cleartax.in/g/terms/transfer-pricing
- https://taxguru.in/income-tax/basics-transfer-pricing-india.html
- https://taxguru.in/income-tax/domestic-transfer-pricing.html

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Unit 12: Performance Evaluation in Multinational Firms

CONTENTS

Objectives

After studying this unit, you will be able to:

- Understand the evolution of performance evaluation in Multinational Firms
- Understand the objectives of performance evaluation in Multinational Firms
- Understand the challenges while drafting a Budget by a foreign entity
- Comprehend the various measures of return in assessing the performance in Multinational Firms
- Understand non-financial measures of evaluating the performance of Multinational Corporations

Introduction

Long before globalization had become a buzz word and a stimulus for companies to invest abroad, enterprises enlarged their “business playing field” into foreign countries for various reasons, such as to capture a new market, to secure resources, or to take advantage of local cost levels. Therefore, subsidiaries are heavily involved in the value creation process for and within multinational corporations (MNCs). However, despite the fact that the measurement of performance is crucial for globally active companies not only in steering the value creation for the MNC but also, for example, in fostering. international expansion or guiding resource allocation, MNCs differ significantly in the extent to which they are aware of the performance of their subsidiaries. Due to the fact that strategic decisions regarding the global expansion of an MNC require a wide and clear information basis to be able to assess how successfully a foreign subsidiary has conducted its business or under what possibly unfavorable environmental conditions the business results were achieved, multinational enterprises have to implement a system for evaluating the performance of their foreign subsidiaries and their management. Although some MNEs are familiar with how their subsidiaries commit to the whole performance, others have an unclear understanding of the input of performance of subsidiaries. To make important strategic selections on international extension, HQ management should be aware how their subsidiaries operate. (Chung et al. 2002, p.112). Besides, managers have to look at subsidiary performance ahead of strategy implementation. As an example can be adjusting strategy with systems and structures. (Wolf and Egelhoff 2001, p. 122-127). A return, also known as a financial return, in its simplest terms, is **the money made or lost on an investment over some period of time**. A return can be expressed nominally as the change in dollar value of an investment over time. There are different Measures of Return among MNC.

12.1 Need for managing the Performance

- Performance management is often connected to employee performance evaluation, however, in the case company, employee performance is part of overall the subsidiary performance evaluation. Performance management is a process of active communication between the supervisor, or, in this thesis case, the HQ office, and an employee or subsidiary.
- The process is ongoing throughout the year and is aimed at support the accomplishment of
  strategic objectives of an organization.
- The communication consists of various parts and can be implemented through different methods, including the setting of objectives, identification of goals, receiving and providing feedback and analysis of the results. (Berkeley.edu)

Problems in measuring and comparing the performance of divisions of a multinational company

1. Economic, legal, political, social and cultural environments differ significantly across countries.
2. Governments in some countries may impose controls and limit selling prices of a company's product.
3. For example, some developing countries impose tariffs and customs duties to restrict the import of certain goods.
4. Availability of materials and skilled labour, as well as costs of materials, labour and infrastructure (power, transportation and communication), may also differ significantly across countries.
5. Divisions operating in different countries keep a score of their performance in different currencies. Issues of inflation and fluctuations in foreign currency exchange rates affect performance measures greatly.

With respect to evaluation, multinational companies should take into account changes in exchange rates, which are the relationships of foreign currencies Jo domestic currency.

One problem for performance evaluation is that the local — the one in a foreign country does business in the foreign currency, but the multinational cares about the results in its home currency (say, Rupees for Indian multinationals).

The trouble is that the local manager and the division can look good or bad in foreign currency (say dollar or pound) simply because of changes in exchange rates, even though he or she is not responsible for exchange rate fluctuations.

12.2 Evolution of Problem

- One of the most dramatic changes witnessed by corporations the world over during the last few decades has been the rapid internationalization of their business.
- This strategy of geographic expansion overtaxed the information processing ability of the chief executives and created the need for a decentralized multidimensional structure.
- The decentralized form of organization, therefore, spread rapidly.
- As Vancil (1979), rightly observes, "if decentralization was a managerial invention in 1920, it was an articulated philosophy by 1950, a reorganizational trend by 1960, and a universal practice by 1970".
- Decentralization is usually achieved by creating units called divisions which may be differentiated either on the basis of the type of goods produced or services provided or along geographic lines within the country itself or beyond its borders.
- In case of multinational firms, this is achieved by establishing or acquiring subsidiaries.
- There could be various reasons for decentralization, including
- enhancing the quality and use of local information gathered
- motivating managers at segment levels and training them to take on greater responsibilities at the center
- (iii) identifying Inefficient units and enhancing the competitiveness and efficiency of the sub-divisions, leading to an overall increase in productivity
- and (iv) releasing the energy of the central management from routine operations to focus on strategic planning and decision-making, which is essential for the survival and long-term growth of the organization.
- A multinational firm may, however, decide to invest abroad for various objectives, such as the need to diversify risks by operating overseas, or to defend its competitive position, obtain raw materials at significantly low costs, take advantage of cheap-skilled labour available abroad or capture new markets for its products and services.
- Coupled with these diverse objectives, the environment in which the different subsidiaries operate renders the domestic management control approach with regard to the evaluation of their performance less satisfactory.
- All these additional variables and circumstances, therefore, necessitate mutations of domestic management structures when applied to evaluating foreign subsidiaries.
- However, in many cases, firms applied domestic practices of performance evaluation with slight modifications to overseas operations for which they were inappropriate.
- As is evidenced from the study by Persen and Lessig (1979) who conclude that: ***Almost without exception, the procedures adopted in measuring domestic profitability were expanded and modified to apply to foreign units when the firm expanded overseas.***
- ***Ninety percent of the respondents reported using identical formats for overseas budgeting operations as used for domestic operations.***
- In fact, in a survey conducted two decades later (Watty and Terizioglu, 1999) the findings were no different.
- They observe "It is interesting to note that in spite of rapid globalization, diverse operating environments, advances in information technology, and adoption of flexible management systems MNCs continue to use identical measures to evaluate the performance of their domestic and foreign subsidiaries".
- The central feature of an organization's effective control system is the performance evaluation of the enterprise.
- Devising an effective system for monitoring the performance of domestic operations is a rather complex issue, but the measurement of an overseas operation is rendered more

complex on account of complicating international variables such exchange rate volatility, foreign inflation, transfer pricing and a host of other environmental effects.

- Shapiro (1978) observed that :Unfortunately, developing an evaluation and control system is still an art, relying on judgement more than theory.
- No universal principles have yet appeared to use in designing such a system for domestic operations, much less for foreign operations.
- Currency fluctuations are at the heart of the distinction between the control of domestic and foreign operations.
- Not only do they disturb budgets, and cash flows from transactions but also distort reported profits when different methods of translations are used by the parent.
- When developing an effective performance evaluation system, the environmental characteristics of a particular country should also be taken into consideration.
- For instance, in some cases, the quality of management in the country in which the affiliate is domiciled might not be as sophisticated as that of the parent; in such a situation, the use of a complex performance evaluation system would be inappropriate.
- Simple evaluation techniques would be more effective. Again, a conflict is bound to arise if the evaluation system does not reflect the specific nature of the foreign operation that may emphasize an objective other than profits. These considerations ought to be considered when designing an evaluation system for a foreign operation.
- The involvement of the foreign managers in the process may prove useful as it would ensure the establishment of an evaluation framework which is sensitive to the local operating environment on the one hand and consistent with overall corporate goals on the other. Some of the other variables that need to be considered include restrictions imposed by nations on remittance of funds, the practice of profit sharing, variations in work ethics or labour productivity.

12.3 Importance of Performance Evaluation

- Evaluation of performance is crucial in favor of exposing the correct image of the activities of subsidiaries. It can notify HQ of fruitful development as well as unfortunate ones.
- Outstanding practices can be deducted when the result of evaluation is good, and initial warnings may be a consequence of negative evaluations (Choi and Czechowicz 1983; Rolander et al. 1989).
- Outstanding practices can be deducted when the result of evaluation is good, and initial warnings may be a consequence of negative evaluations (Choi and Czechowicz 1983; Rolander et al. 1989).
- So, performance evaluation participates in the process of coordination and control within multinational companies. (Egelhoff 1984)
- The objective of the performance evaluation of subsidiaries is finding out the financial and non-financial situation of the developing subsidiary and where profit comes from.(Jingnaet al., 2011).
- Some authors think that the purpose of it is the evaluation and monitoring of the accomplishment of strategic goals and implementation of corporate strategy in the subsidiary.
- The MNC gains a complete picture of all subsidiary activities and determines spaces where it profitably developed them or vice versa - identifies not successful areas that could be managed with higher efficiency.
- The purpose of evaluation can also be local managers' performance evaluation and motivation of employees in the subsidiary. (Schmid &Kretschmer, 2009).

- Evaluation of performance is essential not only in the case of each subsidiary but also at the level of multinational companies, where it can play as a consolidating and coordinating tool for the company as it adds value to consistent actions. (Chang and Taylor, 1999).
- Additionally, in the concept of performance evaluation, subsidiaries can be compared based on distinct criteria that, as a result, may be indispensable for navigating resource allocation in the MNC. (Watty and Terzioglu, 1999).

Significance of budgeting in evaluating the performance in Multinational Firms

12.4 Objectives of Performance Management

A well-designed internal evaluation system serves four important objectives:

- (i) It enables the top management to judge the profitability of the operations, …………….
- (ii) provides an early warning signal for areas that are not within control,
- (iii) optimizes resource allocations, ……..
- (iv) evaluates managerial performance. In a multinational firm, however, the objective of the evaluation system would largely be guided by the….
- For instance, if lowering the cost structure is the motive for establishing a particular subsidiary, the objective of its evaluation system would be the extent to which it has contributed to the MNC in doing so.
- Again, where penetration into new markets A the motive, assessing its profitability, at least in the early years, cannot be an objective of its evaluation system.
- It has to be a non-financial criterion such as market share.

12.5 Budgets as a tool for evaluating the performance in Multinational Firms

- Business budgeting is the most widely used and highest rated management tool of planning and control. Planning is the key to good management as it involves looking systematically at the future.
- Business budgets help managers in developing financial plan to guide them in allocating their resources over a specific future period.
- Control is the process of measuring and correcting actual performance to ensure that plans for implementing the chosen course of action are carried out.
- Multinational companies contend with an array of external factors, internal considerations, and other forces that influence budget policies, composition, and control.
- Budgeting in a global business environment calls for an enhanced level of coordination and communication because of the variety of powerful components that impact organization performance.
- Although the budgeting process for companies can become complex, at its most basic, a budget compares a company's revenue with its expenses in a given period.
- Of course, determining how much to spend on various expenses and projecting sales is only one part of the process. Company executives also have to contend with a myriad of other factors, including projecting capital expenditures, which are large purchases of fixed assets such as machinery or a new factory.
- They must also plan for their ongoing cash needs, revenue shortfalls, and the economic backdrop. Regardless of the type of business, the ability to gauge performance using budgets is critical to a company's overall financial health.

- Comparison of actual performance with that of planned financial performance in case of operating budget is the most common method of evaluating performance of foreign affiliates.
- One of the principal tool for communication in multinational firms and helps to knit together its heterogeneous subunits.
- Complexities encountered in budgeting for overseas operations evolve around exchange rate considerations.

12.6 Fundamental issues involved in Budgeting

i. Which exchange rate to be used for budgetary planning and reporting performance?

ii. Should managers of foreign affiliates be held liable for exchange rate variance?

Factors affecting Budgeting for Overseas Operations

- Foreign currency exchange rates
- inflation
- interest rates

Currency Considerations

- Currency considerations further complicate the performance evaluation in Multinational Corporations.
- In fact, it is one of the major issues involved, as assessment of a foreign subsidiaries' performance is considerably influenced by currency framework employed.
- A foreign operations' financial performance can be evaluated in terms of local currency (subsidiary) or home country currency (parent) or may be both.
- Those who advocate the use of parent currency in measuring performance put forward the argument that the shareholders in the parent country, …………….
- in the final analysis, are basically interested in profits expressed in their own currency rather than currency of subsidiary.
- Again, it permits comparison with other subsidiaries of the same parent.
- On the other hand, the use of local currency is supported by those who feel that since the transactions take place in a foreign currency, adoption of this approach would eliminate the consideration of foreign currency translation gains and losses. The manager of the foreign subsidiary is, therefore, evaluated on the basis of his ability to compete in terms of local currency.
- It thus eliminates from the evaluation process an item (exchange gains and losses) over which the manager generally has no control.
- The currency framework employed, however, should necessarily be related to the fundamental question—who is responsible for exchange risks?
- Where the local managers are entrusted with the necessary tools to hedge the environmental risks, it would be logical to hold them responsible for exchange gains and losses and to adopt a parent currency framework.
- Alternatively, if the headquarters shoulders the responsibility of managing foreign exchange risks concerning both transaction and translation, the local currency framework is justified.

Exchange Rate combinations in Budgetary Control

- It is important to note that budgets do not appear out of thin air. It requires a lot of thinking at the organizational level.

- While preparing budgets to evaluate performance of foreign subsidiaries, management faces tricky question of which rate is to be made use of?
- It is imperative as use of different rates for preparing budget and tracking the performance gives rise to a variance over and above that results from price and volume changes.
- Generally three possible rates can be used in setting an operational budget:

  i. Actual spot rate in effect at the time of budget preparation

  ii. *A forecast rate for the end-of-the-budget period*

  iii. Actual rate at the end-of-the-budget period, if budget is updated every time the exchange rate fluctuates

- Similarly, comparable rates can be used for the purpose of monitoring actual performance in relation to the budget.

Inflation

- Evaluation of foreign affiliates is further complicated by Inflation.
- It is quiet imperative to understand that evaluation by the same yardstick of subsidiaries located in low inflation and in high inflation economics would not be appropriate.
- Inflation has an effect upon the earnings and not adjusting for it generally results in overstating the computed return on investment, since current prices of the product are matched with outdated costs of production.
- Consequently, what looks like a good performance by managers may merely be the result of inflationary processes at work.

An optimistic appraisal of performance of the unit is the outcome of the following factors:

- *1. Profitability measured according to ROI is overstated as it is measured in relation to an inaccurately small investment base.*
- *2. Depreciation is understated being based on historic costs.*
- *3. Accumulated depreciation is not adequate to replace assets.*
- Solution to these problems is not readily formulated, the use of replacement costs for assets perhaps remedies them to an extent, but it creates problems of its own.
- Most companies, however, do not incorporate inflation adjustments into their performance evaluation system. This was revealed even in the surveys conducted by researchers.
- Persen and Lessig (1979) found that only 30 per cent of the companies surveyed incorporated inflation adjustments into their performance system.
- The results of the Watty and Terizioglu (1999) revealed a marginal difference in the percentage, 72 per cent did not incorporate such adjustments only 28 percent did.
- Adjustments are however, made for subsidiaries situated in hyperinflationary environments.

Interest Rates

- A country's monetary policy and actions towards interest rates are often driven by several macroeconomic factors.
- In addition, public sentiment towards the country, it's government, and its economic standing play an important part as well.
- A country often issues monetary policy impacting national interest rates to achieve specific economic goals. Whether the country is attempting to promote job creation or stem inflation, the country is intentionally manipulating the monetary supply, availability of credit, and cost to borrow money.

- As a result, monetary policy changes that impact national interest rates change the value of that country's currency.
- A residual impact of raising or decreasing interest rates is that country's currency's value will become stronger or weaker, and downstream impacts on global exchange rates occur.
- Higher interest rates in a country can increase the value of that country's currency relative to nations offering lower interest rates.
- Political and economic stability and the demand for a country's goods and services are also prime factors in currency valuation.
- Analysts often track a country's balance of trade and financial stability to determine the relative strength of a country's currency.
- Inflation can lead central banks to set higher interest rates to help cool down a hot economy.

12.7 Measures of Return among MNC

Return on Investment

Percentage of return on total capital employed in business.

- Operating Profit X 100

  Capital Employed

LIVE Example - Indian multinational pharmaceutical company

	CIPLA (in Rs. Cr.)			Torrent Pharmac (in Rs. Cr.)		
Year	Profit/Loss Before Tax	Shareholder Fund	Long-term borrowing	Profit/Loss Before Tax	Shareholder Fund	Long-term borrowing
2022	3546.23	22,513.55	NIL	1466.21	6345.42	1,971.60
2021	3350.66	19,927.56	NIL	1366.11	6030.1	2,941.07
2020	2964.31	17,402.96	NIL	1116.77	5120.97	3,124.45

Solution:

	CIPLA (in Rs. Cr.)	Torrent Pharmacy (in Rs. Cr.)
Years	ROI	ROI
2022	0.16	0.17629
2021	0.17	0.152278
2020	0.17	0.135441

Return on Assets

- The return on assets ratio, often called the return on total assets, is a profitability ratio that measures the net income produced by total assets during a period by comparing net income to the average total assets.
- You can look at ROA as a return on investment for the company since capital assets are often the biggest investment for most companies. In this case, the company invests money into capital assets and the return is measured in profits.

$$\text{Return on Assets} = \frac{\text{Net Profit After Taxes}}{\text{Average Total Assets}} \times 100$$

LIVE example of CIPLA and Torrent Pharma for calculating return on assets ratio

CIPLA	Mar-22	Mar-21	Mar-20	Mar-19
Total Assets	25,449.05	22,963.74	20,405.66	18,418.81
Profit/Loss After Tax	2,689.39	2,468.28	2,318.17	1,888.41

Torrent Pharma	Mar-22	Mar-21	Mar-20	Mar-19
Total Assets	11,152.56	11,761.04	11,884.47	12,027.27
Profit/Loss After Tax	991.45	1,137.85	938.51	745.42

CIPLAs' Average Assets in 2022 =36930.92

Average Assets in 2021 = 33166.57

Torrent Pharamas' Average Assets in 2022 = (11,761.04+11,152.56)/2 = 17033.08 and Average Assets in 2021 = (11,761.04+11,884.47)/2 = 17033.08

CIPLAs' ROA in 2022 = 991.45 / 17033.08 = 0.072822 and ROA in 2021 = 1,137.85 / 17703.275 = 0.074421

Torrent Pharmas' ROA in 2022 = 991.45 / 17033.08 = 0.058207324 and ROA in 2021 = 1,137.85 / 17703.275 = 0.064273418

ROA calculation results

	CIPLA	Torrent Pharma
2022	0.072822	0.058207324
2021	0.074421	0.064273418

Return on Equity

- Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Shareholders' Equity}}$$

- Whether an ROE is deemed good or bad will depend on what is normal among a stock's peers.
- For example, utilities have many assets and debt on the balance sheet compared to a relatively small amount of net income.
- A normal ROE in the utility sector could be 10% or less. A technology or retail firm with smaller balance sheet accounts relative to net income may have normal ROE levels of 18% or more.
- Still, a common shortcut for investors is to consider a return on equity near the long-term average of the S&P 500 (14%) as an acceptable ratio and anything less than 10% as poor.

Live example:

- You are given that Apple share holder equity for 2022 is $50.672 Billion and its reported net income = 99.8 billion U.S. dollars. Calculate ROE of Apple company.
- ROE = 99.8 billion U.S. dollars / 50.672 U.S Billion = 1.9695:1 OR 2:1
- Likewise we can compute its competitors ROE like Amazon.com; Microsoft Corp. and Google. The one with higher ratio as per the Industry is obvious better performer internationally.

Return on Sales

- Return on sales (ROS) is a ratio used to evaluate a company's operational efficiency. This measure provides insight into how much profit is being produced per dollar of sales.
- An increasing ROS indicates that a company is improving efficiency, while a decreasing ROS could signal impending financial troubles. ROS is closely related to a firm's operating profit margin.
- Return on sales (ROS) is a measure of how efficiently a company turns sales into profits.

$$ROS = \frac{\text{Operating Profit}}{\text{Net Sales}}$$

where:

ROS = Return on sales

Operating Profit is calculated as earnings before interest, or EBIT.

- Assume that Nestle Indias' Operating Profit = Rs. 906.24 crores and its Net Sales = Rs. 4591.00 crores. Return on Sales in case of Nestle India = 906.24 / 4591 = 0.197:1 in 2022
- When calculating return on sales, investors might notice that some companies report net sales while others report revenue.
- Suppose, a company that generates $100,000 in sales and requires $90,000 in total costs to generate its revenue is less efficient than a company that generates $50,000 in sales but only requires $30,000 in total costs.
- ROS is larger if a company's management successfully cuts costs while increasing revenue.

- Using the same example, the company with $50,000 in sales and $30,000 in costs has an operating profit of $20,000 and a ROS of 40% ($20,000 / $50,000).
- If the company's management team wants to increase efficiency, it can focus on increasing sales while incrementally increasing expenses, or it can focus on decreasing expenses while maintaining or increasing revenue.
- Multinational corporations place heavy reliance on operating budget comparison for evaluating foreign subsidiaries. Return on Investment ranks next most important.
- Return on assets and operating cash flows were also employed by some MNCs for evaluation purpose.
- The least popular measures are return on equity and contribution to earning per share.
- Another significant revelation was that the same financial and non-financial criteria were employed in evaluating the performance of the units and their managers.
- Thus, budgeted performance and return on investment have been identified as the most widely used financial criteria for performance evaluation by MNCs.

12.8 Other Measures

- Contribution to Earning per Share
- Contribution to Corporate Cash Flows
- Asset/Liability Management

Live example: Annual Statement Extract of Nestle India – No. of Equity Shares

NOTES FORMING PART OF THE FINANCIAL STATEMENTS

	As at 31 December 2021		As at 31 December 2020	
	No. of shares	Amount (₹ in million)	No. of shares	Amount (₹ in million)
19 - EQUITY SHARE CAPITAL				
Authorised				
Equity shares of face value ₹ 10 each	**100,000,000**	**1,000.0**	100,000,000	1,000.0
Issued, subscribed and fully paid up				
Equity shares of face value ₹ 10 each	**96,415,716**	**964.2**	96,415,716	964.2

Live example: Nestle India – Profit After Tax [PAT]

10 - Year Financial Highlights

₹ in Millions (except otherwise stated)

	2021	2020	2019^	2018	2017	2016	2015*	2014	2013	2012
Results										
Sales	146,337	132,902	122,953	112,162	101,351	94,096	81,233	98,063	90,619	83,023
Profit from Operations	32,548	28,775	25,940	23,509	18,305	16,542	13,338	17,926	16,941	15,400
as % of Sales	22.2	21.7	21.1	21.0	18.1	17.6	16.4	18.3	18.7	18.5
Profit after Tax	21,449	20,824	19,684	16,069	12,252	10,014	5,633	11,847	11,171	10,679
as % of Sales	14.7	15.7	16.0	14.3	12.1	10.6	6.9	12.1	12.3	12.9

Annual Report Extract - Earning Per Share Nestle India calculation

Basic earnings per share is computed by dividing the net profit for the period attributable to the equity shareholders by the weighted average number of equity shares outstanding during the period.

For the purpose of calculating diluted earnings per share, the net profit for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period are adjusted for the effects of all dilutive potential equity shares, if any.

Solution to Live example: Nestle India – Earning Per Share calculation

	2021	2020	2019	2018	2017
Weighted average number of equity shares	9,64,15,716	9,64,15,716	9,64,15,716	9,64,15,716	9,64,15,716
Profit after Tax	21,449	20,824	19,684	16,069	12,252
Earning Per Share	0.000222464	0.000215981	0.000204158	0.000166664	0.000127075

- **Here, in the table we see that the earning per share**

In FY 2017 = 0.000127075; **2018 =** 0.000166664

2019 = 0.000204158; **2020 =** 0.000215981 and **2021 =** 0.000222464

- It is quiet clear that in 2021 the companys' EPS has improved noticeably in comparison to past 4 years. This is a healthy sign to attract more investment and a promising future growth.

2nd Measure : Contribution to Corporate Cash Flows

- Cash flows are considered as important elements for the valuation process because a company's current value is the present value of the cash flows that are expected to be in the
future.
- Cash flows are considered as important elements for the valuation process because a company's current value is the present value of the cash flows that are expected to be in the
future.
- So, when the financial analyst figures out past and present cash flows, it may be a great hint for future cash flows' forecasting, and, as a result, in the determination of the organization's value. Furthermore, the ability to understand cash flow helps the analyst evaluate the company's capability to retain current dividends and its policy for capital expenditure without counting on the financing from external sources.
- One of the simplest examples of calculating of cash flow of the company is: Estimated cash flow = Net income + (depreciation + amortization)

3rd Measure: Asset/Liability Management

- Asset/liability management is the process of managing the use of assets and cash flows to reduce the firm's risk of loss from not paying a liability on time.
- Well-managed assets and liabilities increase business profits. The asset/liability management process is typically applied to bank loan portfolios and pension plans. It also involves the economic value of equity.
- The concept of asset/liability management focuses on the timing of cash flows because company managers must plan for the payment of liabilities.
- The process must ensure that assets are available to pay debts as they come due and that assets or earnings can be converted into cash. The asset/liability management process applies to different categories of assets on the balance sheet.
- **[Important: A company can face a mismatch between assets and liabilities because of illiquidity or changes in interest rates; asset/liability management reduces the likelihood of a mismatch]**

Asset Coverage Ratio

- An important ratio used in managing assets and liabilities is the asset coverage ratio which computes the value of assets available to pay a firm's debts.

$$\text{Asset Coverage Ratio} = \frac{(\text{BVTA} - \text{IA}) - (\text{CL} - \text{STDO})}{\text{Total Debt Outstanding}}$$

where:

BVTA = book value of total assets

IA = intangible assets

CL = current liabilities

STDO = short term debt obligations

- Tangible assets, such as equipment and machinery, are stated at their book value, which is the cost of the asset less accumulated depreciation.
- Intangible assets, such as patents, are subtracted from the formula because these assets are more difficult to value and sell. Debts payable in less than 12 months are considered short-term debt, and those liabilities are also subtracted from the formula.
- The coverage ratio computes the assets available to pay debt obligations, although the liquidation value of some assets, such as real estate, may be difficult to calculate. There is no rule of thumb as to what constitutes a good or poor ratio since calculations vary by industry.

Non-financial measures

- Customer Satisfaction
- Market Share
- Productivity
- Measuring Cost of Quality
- Personnel Development
- Employee Attitude

12.9 Issues in Performance Evaluation

- Performance evaluations are carried out by both domestic and multinational enterprises.
- However, due to structural variations between the two entities, the performance evaluation processes differ.
- For example, all employees should be evaluated, which implies businesses should develop uniform evaluation processes to save time and assure fairness.
- However, the technique does not apply to all employees, and multinational structures, as opposed to domestic ones, complicate the procedure even more due to cultural and legal variances.
- As a result, differing cultural norms and legal constraints influence performance appraisals for both domestic and multinational corporations.

Summary

When talking about performance measurement, it is essential to mention the source of performance measurement: it can be either subjective or objective, where subjective stands for primary source of data and objective for secondary. Literature review on the subject has shown that researchers tend to use subjective data in their articles. However, papers that assess the financial dimension usually use objective data. MNCs base their offices and plants in a number of host countries, controlling the production facilities from the headquarters. Depending on the style of operations, different performance evaluation systems will suit different companies. Often quantitative measures are recognized as objectively measured. On the other hand, qualitative measures suggest a certain amount of subjectivity. Generally, qualitative criteria are more challenging to measure than in the case of quantitative. Under the financial measures there are other measures that can be used to assess the performance of a foreign entity.

Keywords

- Customer satisfaction: This is a measure of how products and services supplied by a company meet or surpass the customer expectation.
- Market share: In strategic management and marketing, market share is defined as the percentage or proportion of the total available market or market segment that is being serviced by a company.
- Productivity: This is an efficiency measure that relates the output of a given unit to the inputs used in the production of the outputs. Thus, in simple terms, productivity = output/input. Productivity is a key measure of the relative competitiveness of the affiliate.
- Appraisal Cost: These costs are referred to as monitoring or inspection costs, and includes costs incurred to identify defective products. Inspection, testing and other quality control functions belong to this category.
- Prevention costs: The prevention costs era came into existence when it dawned on companies that appraisal costs do reduce the number of defective products before they get to the customers, but do not reduce the number of internal failures

Self Assessment

1. This category covers costs which arise when the defective units have not been detected on time, or prevented from being produced and they reach the customers.

A. External failure costs
B. Internal failure costs
C. Appraisal Cost
D. Prevention costs

2. These costs are referred to as monitoring or inspection costs, and includes costs incurred to identify defective products. Inspection, testing and other quality control functions belong to this category.

A. External failure costs
B. Internal failure costs
C. Appraisal Cost
D. Prevention costs

3. Expenses of maintaining the quality control department; evaluation of methods, materials, and processes; and product samples used in testing are examples of

A. External failure costs
B. Internal failure costs
C. Appraisal Cost
D. Prevention costs

4. This includes costs of defective products that are scrapped

A. External failure costs
B. Internal failure costs
C. Appraisal Cost
D. Prevention costs

5. Discounts allowed on disposal of substandard parts and materials is an example of …

A. External failure costs
B. Internal failure costs
C. Appraisal Cost
D. Prevention costs

6. It measures the investment in human resources, the contribution of employee training programmes to promotion is monitored
A. Customer Satisfaction
B. Market Share
C. Productivity
D. Personnel Development

7. What is termed as Percentage of return on total capital employed in business?
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

8. ……is a profitability ratio that measures the net income produced by total assets during a period by comparing net income to the average total assets.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

9. This ratio indicates how well a company is performing by comparing the profit (net income) it's generating to the capital it's invested in assets.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

10. …..is a measure of financial performance calculated by dividing net income by shareholders' equity.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

11. The higher the……, the better a company is at converting its equity financing into profits.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

12. ……..is a ratio used to evaluate a company's operational efficiency.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

13. It measures the performance of a company by analyzing the percentage of total revenue that is converted into operating profits.
A. Return on Investment
B. Return on Assets
C. Return on Equity
D. Return on Sales

14. ………..has been identified as one of the most widely used financial criteria for performance evaluation by MNCs
A. Customer Satisfaction
B. Market Share
C. Productivity
D. return on investment

15. ……..……….has been identified as one of the most widely used financial criteria for performance evaluation by MNCs
A. Customer Satisfaction
B. Market Share
C. Productivity
D. Budget

Answers for Self Assessment

l.	A	2.	C	3.	C	4.	B	5.	B
6.	D	7.	A	8.	B	9.	B	10.	C
11.	C	12.	D	13.	D	14.	D	15.	D

Review Questions

1. What are the financial measures of performance evaluation?
2. What are the non-financial measures of performance evaluation?
3. What are the most widely used financial measures of performance evaluation and why?
4. What are the objectives of performance evaluation?
5. What is the importance as a measure of performance evaluation?

Further Readings

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Unit 13: Strategic Accounting Issues in MNCs

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the function of accounting in the development of international corporate strategies.
- Describe the elements that influence the implementation of a multinational corporation's strategy.
- Examine the role of accounting in the implementation of global corporate strategies.
- Recognize the problems involved in designing and implementing an effective performance evaluation system within a multinational organisation.
- Describe how cultural diversity affects strategic accounting challenges in a global firm.

Introduction

Strategies are broad plans that reflect the organization's future orientation as defined by top management. A strategic decision is one made by a multinational corporation (MNC) to achieve at least 50% market share for one of its products in a specific foreign country within a specified time frame. Domestic and global firms face many of the same strategic difficulties, which can be divided into two major categories: strategy creation and strategy implementation. Strategy formulation is the process of determining the organization's goals and tactics for achieving those goals. The process through which managers influence other members of the organisation to behave in accordance with the organization's aims is referred to as strategy implementation. Managerial influence is often referred to as management control. Through the activities of capital budgeting, operational budgeting, and performance review, an organization's accounting function plays a key role in strategy creation and implementation.

13.1 Formulation of a Strategy

- The key to developing a strategy is information. Creating a strategy entails assessing data regarding both internal and external elements.
- Internal factors refer to the organization's levels of skill and know-how in areas such as technology, manufacturing, marketing, and distribution, as well as its culture, whereas external factors refer to competitors, customers, and suppliers, as well as other regulatory, social, and political factors.
- The examination of these variables enables managers to discover opportunities and match them with existing resources in order to develop strategies
- The fundamental goal of strategy development is to ensure that the company achieves its objectives, which are typically geared at improving the firm's value.
- Accounting may aid in strategy formulation by measuring opportunities and risks, as well as strengths and weaknesses, and producing cost-benefit estimates as financial expressions of strategy.
- A corporation's mid-term strategy as outlined in its 2012 annual report.
- The budgeting process is when accounting makes the most of its contribution to MNC strategy formulation.
- The first step in implementing change in an organisation is to create a budget.
- Transferring information to decision makers is a crucial function of budgeting.
- Budgeting compels managers to consider strategy since it formalises responsibilities for both short- and long-term planning.
- Budgeting also identifies specific expectations that can be used to evaluate future performance.

Capital Budgeting in MNCs

- The calculation of net present value (NPV) for a foreign investment project is more complicated than for a domestic project, owing to the additional risks that affect future cash flows.
- Political risk, economic risk, and financial risk are the three primary types of hazards that MNCs face.
- Political risk is the probability that political developments in a host country will have a negative impact on cash flows obtained from an investment in that country.
- The most extreme kind of political risk is the host government's nationalisation or expropriation of assets with or without recompense to the investor.
- Foreign exchange controls, constraints on profit repatriation, local content legislation, changes in tax or labour laws, and mandates for more local production are all examples of political risk.
- Special rules and regulations established by foreign governments can also have an impact on cross-border commerce.
- Economic risk refers to concerns about the state of the host country's economy.
- Economic risk includes inflation and the country's balance of payments situation.
- Continuous deterioration of a country's balance of payments condition may result in currency depreciation, exacerbating the problem of inflation.
- Inflation affects an economy's cost structure as well as the ability of the local populace to afford goods and services.

- The price of imported items in the host country rises as a result of devaluation.
- Inflation raises the cost of doing business in a foreign nation because managers invest time and resources in developing methods to deal with quickly changing costs.
- The danger of loss owing to unanticipated changes in currency values, interest rates, and other financial events is referred to as financial risk.
- Foreign exchange risk refers to the extent to which a company is influenced by fluctuations in exchange rates.
- There are three categories of exposure to foreign exchange risk, as detailed later in this chapter: balance sheet exposure, transaction exposure, and economic exposure, all of which have an impact on cash flows.
- The first factor to consider when examining a possible foreign investment project is whether it should be evaluated based on project cash flows (in local currency) or parent cash flows (in parent currency), taking into account the quantities, timing, and forms of transfers to the parent business.
- Project cash flows are particularly vulnerable to economic and political risk, whereas parent company cash flows can be significantly influenced by political and foreign exchange risk.
- MNCs typically analyse foreign investments from both the project and parent perspectives.
- The following are factors that differ between countries and should be addressed when considering a potential foreign investment from a project standpoint:
    - Taxes. Income and other tax rates, import levies, and tax breaks all have a direct impact on cash flows.
    - Inflation rate. Over time, inflation can affect a project's competitive position, cost structure, and cash flow.
    - Political danger. Government action in the economic environment, such as the enforcement of local content regulations or pricing controls, can cause predicted cash flows to change.
- Additional aspects should be addressed when analysing a foreign investment from the standpoint of the parent company:
- The method by which money is transferred to the parent. Dividends, interest, and royalties may all be subject to varying withholding tax rates.
- Expected changes in the exchange rate over the course of the project. This will have a direct impact on the value of local cash flows to the parent.
- Political danger. The host government's foreign exchange and/or professional repatriation regulations may limit the amount of cash fl ow to the parent.
- These factors can be incorporated into the foreign investment examination in two ways:
- The factors are factored into predictions of future cash flows.
- To account for the risk associated with changes in these various elements, the discount rate used to calculate the present value of predicted future cash flows is increased (upward).

13.2 Implementation of the Strategy

- Management control is the function of ensuring that an organization's strategies are implemented and goals are met.
- Management control systems are tools for executing and assessing strategies' efficacy.
- Accountants play an important role in management control by developing operating budgets and implementing performance evaluation methods.

- Operating budgets assist describe a firm's long-term strategy in shorter time frames, give a system for monitoring strategy implementation within that time frame, and specify performance criteria.
- A multitude of factors, such as organisational structure and country culture, influence strategy implementation inside an organisation.
- In this section, we will provide a brief description of these other elements in respect to MNC management control systems.

1. Management Control

Management control entails planning what the organisation should do to effectively implement strategy, coordinating the activities of various parts of the organisation, communicating information to organisational members, evaluating information, deciding what action to take, and inciting organisational members to change their behaviour in accordance with the organization's strategy.

- In management control, the amount to which decision-making authority is given to other members of the company is an essential problem.
- In the case of MNCs, for example, some amount of delegation to subsidiary managers is unavoidable due to the requirement to respond to local conditions and provide a mechanism for motivating subsidiary managers.
- However, the issue of delegation is especially complicated for MNCs since geographically scattered subsidiary managers may strive toward parochial purposes that may conflict with the interests of the organisation as a whole.
- As a result of delegating decision-making authority to subsidiary managers, effective control mechanisms are required to ensure that subsidiary managers behave in accordance with organisational goals, also known as goal congruence.
- Determining the right level of authority to delegate to foreign operations and designing the relevant control structure required to achieve goal congruence are important challenges for MNCs in plan implementation.
- The organisational structure of the company and the strategic function allocated to subsidiaries are important elements that influence the design of an effective control system for an MNC.
- MNCs structure their cross-border activities in various ways based on their primary goal.
- **Ethnocentric organisational structure:** When a multinational corporation concentrates on creating goods for the parent company's market, its organisational structure is ethnocentric.
- Firms that follow the ethnocentric principle believe that their own cultural heritage, including values, ideas, language, nonverbal communication, and problem-solving methods, is generally relevant.
- In contrast, some MNCs concentrate on offering products to the host country through a distinct product strategy.
- In this situation, subsidiaries serve as strategic business units.
- Such a firm's structure can be described as polycentric. Polycentricism implies that the host country's culture is significant and should be adopted.
- Obviously, this raises the issue of adjusting to multiple cultures within the organisation as a whole.

- In order to satisfy changing market demands, some firms have a global networked structure that supports both product line and geographic divisions. This type of structure is known as geocentric.
- **A geocentric MNC**: It organises its activities as a network of exchanges in knowledge, goods, and money among subsidiaries in several countries. The fi rm can identify distinct responsibilities for subsidiaries by focusing on knowledge flows. A global innovator is a subsidiary that acts as a source of expertise for other units and takes the lead in a specific sector.
- The extent to which responsibilities are allocated to specific foreign operations is influenced by organisational structure.
- The level of delegation to the individual foreign subsidiary is greater when the focus of a subsidiary's activities is on the host nation (a polycentric organisational structure) than when the focus is on the synergy of activities in multiple countries (a geocentric organisational structure).
- The level of delegation appropriate for a single subsidiary can also be determined by the strategic function allocated to it.
- Because of the lesser level of interdependence between the local innovator and its peer units, a subsidiary acting as a local innovator may have a higher level of responsibility than one acting as an integrated player.
- To control subsidiaries, corporate management has two primary control systems: bureaucratic (output) control and cultural (behavioural) control.
- For example, US MNCs exert greater control (i.e., bureaucratic control) over their subsidiaries than European firms, which tend to utilise more behavioural (cultural) control over their foreign operations.
- European MNCs, on the other hand, tend to appoint more parent company nationals to important positions in overseas subsidiaries and rely on a higher level of behavioural control than their American counterparts.
- A bureaucratic control system makes heavy use of rules, regulations, and procedures that clearly define the function and authority of subsidiary management and spell forth expected performance in terms of identified targets such as financial goals.
- These goals serve as the foundation for measuring success.
- In contrast, broad organisational culture is critical in a system of cultural control.
- A cultural control system is less formal and more implicit than a bureaucratic control system. Budgeting, for example, contains both bureaucratic and cultural elements.
- The bureaucratic component of budgeting is in setting specific goals to fulfil, while the cultural component is in the function budgeting plays in modifying behaviour patterns within an organisation.

Operational Budgeting

The primary contribution of accounting to plan implementation is operational budgeting.

Whereas long-term budgets are primarily used for strategy creation and long-term planning, annual operational budgets aid in the expression of a firm's long-term strategy over shorter time frames.

Operational budgets provide tools for translating organisational goals into monetary terms, allocating responsibilities and finite resources, and monitoring actual performance.

Budgeted figures become goals for managers to strive for.

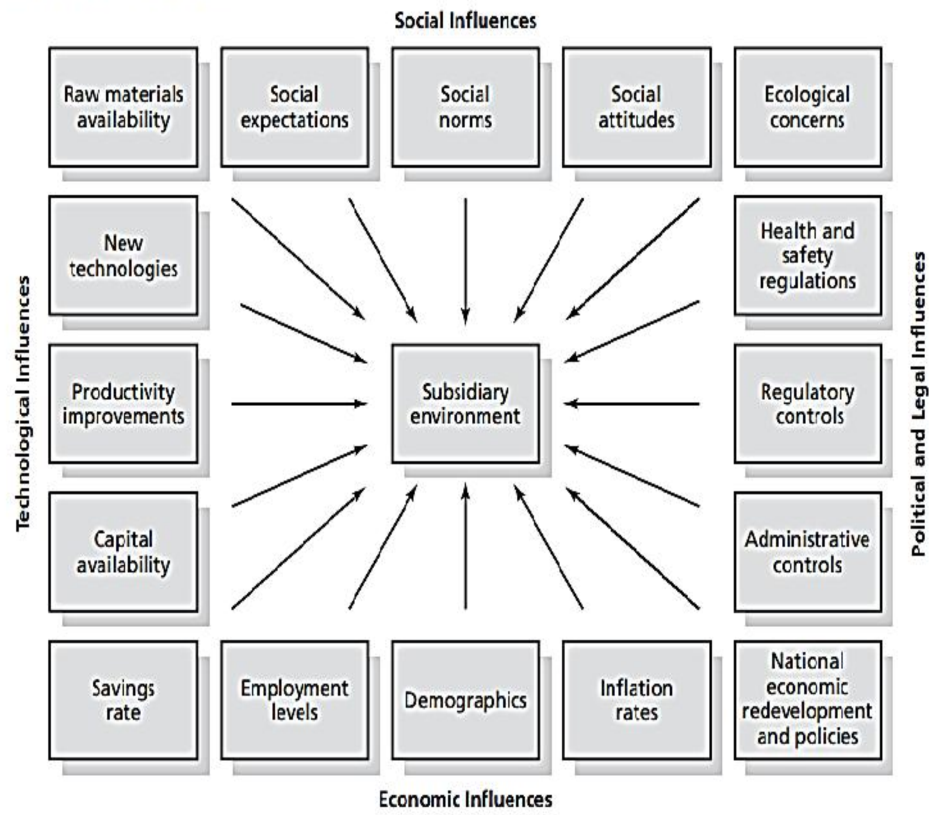
Many multinational corporations find it necessary to translate the operational budgets of their international operations using an acceptable exchange rate.

This approach is exacerbated by exchange rate fluctuations.

The following section addresses difficulties with the performance evaluation of international operations.

13.3 Evaluating Foreign Operations' Performance

- The purpose of performance evaluation is to monitor an organization's efficacy in achieving its goals. It is an important management control task.
- In addition to providing measurements for evaluating management performance, corporate management expects the performance evaluation system to assist in assessing the viability of current operations, identifying areas that require more attention, and allocating precious resources efficiently.
- Furthermore, performance evaluation and reward systems are required to drive organisational members to behave in accordance with the organization's aims.
- Performance evaluation tools that seek to capture these intricacies are bound to be subjective.
- Furthermore, companies do not appear to adopt a uniform technique of performance evaluation. According to a research done by the Chartered Institute of Management Accountants (CIMA) in the United Kingdom, most organisations do not regularly utilise a particular strategy, despite consulting and academic literature on multiple ways to performance evaluation.
- For example, British corporations use a contingency approach based on the environment in which they operate, their structure and size, and their technology capabilities.
- According to the CIMA study, the focus of performance measurement in the 1980s was overly historical.
- Companies believed they were measuring the wrong things.
- Companies in the 1990s struggled to develop measurement frameworks and were concerned about having too many performance measurements.
- All of these concerns remain pertinent in the new millennium.



These are the influences Affecting the Operating Environment of Subsidiaries in Foreign Countries

Source: H. Noerreklit and H. W. Schoenfeld, "Controlling Multinational Companies: An Attempt to Analyse Some Unresolved Issues," International Journal of Accounting 35, no. 3 (2000), pp. 415–30. Source:

- Even in a purely domestic context, performance appraisal is a challenging subject.
- It gets much more complicated in an international context, owing to concerns peculiar to overseas operations, such as exchange rate fluctuations, differing rates of inflation in foreign nations, international transfer pricing, and cultural and environmental variances that exist across countries.
- It is critical to ensure that the performance targets established for a foreign subsidiary are consistent with overarching business goals and strategy while also being appropriate for the local circumstances.
- The remainder of this section goes into greater detail about the issues involved in establishing and executing a system for evaluating the performance of a foreign subsidiary.

Designing of an Effective Performance Evaluation Structure for a Foreign Subsidiary

Designing an effective performance evaluation system necessitates considerations on the following:

1. The metric or metric set against which performance will be measured.

2. The international operation is viewed as a cost, profit, or investment centre.

3. The distinction between evaluating the foreign operating unit and evaluating the management of that unit.

4. The way of assessing profit for those foreign activities based on profitability.

In these cases, there are no generally correct or incorrect decisions.

There is no universally applicable performance evaluation system, nor are there established rules that businesses must follow. Each organisation will have its own system that is customised to its strategic goals.

Performance Metrics

- Companies must determine whether to monitor and evaluate performance using financial factors, nonfinancial criteria, or a combination of the two.
- Given the various contexts in which MNCs operate and the interdependencies among units in a multinational context in today's global climate, formulating a global business plan can be a difficult process.
- A possible issue for MNCs in this regard is headquarters' reliance on simple financial control systems, which are frequently intended for home-country operations and extended to international subsidiaries.
- Unless these technologies are tailored to the local operational environment, subsidiary managers may be particularly sensitive to them.
- The risk here is that improper performance criteria may result in dysfunctional conduct that is incompatible with organisational aims.

Financial Metrics

- Financial metrics are performance indicators that are based on accounting data. Sales growth, cost reduction, profit, and return on investment are among them.
- Several surveys have questioned multinational corporations which financial measures they use to evaluate the performance of their foreign operations.
- The top three financial measures used in evaluating foreign subsidiary performance by both US and UK MNCs in all four polls are profit, ROI, and comparison of planned and actual profit, however the order varies significantly between the four studies.
- Given the high number of corporations that use each measure, it is apparent that MNCs utilise a variety of financial metrics to assess the performance of their international operations.

Nonfinancial Metrics

- Nonfinancial metrics of performance are those that are based on information other than financial statements.
- In 1983, a survey of US multinational corporations was done to examine the use of various nonfinancial indicators in evaluating the performance of foreign operations.
- Respondents were asked to rate the importance of each measure in evaluating (1) the foreign subsidiary and (2) the manager of the foreign company on a scale of 1 (very important) to 4 (not important).
- According to survey respondents, market share is the most important nonfinancial metric of performance. Relationship with the host country government, quality control, and productivity improvement were also essential metrics.
- Nonfinancial indicators like community service and workforce turnover were rated less essential. Overall, nonfinancial and less quantifiable measures are more subjective than financial measures.
- In general, the manner of evaluation is heavily influenced by the type of subsidiary involved. When reviewing a subsidiary with specific tasks, such as a sales unit, it is typical to apply simple and straightforward criteria.

- The number of new consumers, market share, or a mix of similar indicators are among the factors used to evaluate such affiliates.

The Balanced Scorecard (BSC): Augmented Significance of Non-financial Measures

- A balanced scorecard combines financial and nonfinancial measurements of past performance to offer management with a road map for building shareholder value.
- A balanced scorecard, focuses on an integrated link among the essential aspects of a company—vision, strategy, and four perspectives, namely financial, customer, internal business process, and learning and growth.
- The learning and growth viewpoint describes how the company will maintain its ability to evolve and improve in order to attain its vision.
- In today's world of rapid technological development, it is becoming increasingly important for both managers and other staff inside a company to remain in a continuous learning mode.
- A balanced scorecard includes performance indicators for each of the four perspectives.
- Nonfinancial indicators are linked to three of the four balanced scorecard views.

ResponsibilityCentres

- A corporation must decide whether to view a foreign affiliate as a cost centre, a profit centre, or an investment centre.
- Cost-center managers are prone to Managers of other responsibility centres within a group have the least degree of responsibility. They typically do not have the authority to sell existing assets or acquire new assets.
- Cost centres are required to generate as much as feasible for a particular number of resources (e.g., internal service units of an organisation such as accounting, manufacturing, and research and development) or to produce a specified amount of output at the lowest possible cost.
- When an operating unit is treated as a cost centre, responsibility is allocated only to cost control and reduction, not to revenue generation.
- Evaluation as a profit centre implies that profit will be utilised to determine if the operating unit is meeting its objectives and that resources will be allocated based on profit.
- In effect, the operating unit and its management are held accountable for profit generation. Professional centre managers are assigned a specific number of assets and are ultimately accountable for both expenditures and income.

Type of Responsibility Center	Responsibilities	Performance Measurement
Cost center	Choose output for a given cost of inputs or Choose input mix to achieve a given output	Output (maximize given quality constraints) or Cost (minimize given quality constraints)
Profit center	Choose inputs and outputs with a fixed level of investment	Profit (maximize)
Investment center	Choose inputs, outputs, and level of investment	Return on investment, residual income (maximize)

Source: Adapted from Cheryl S. McWatters, Dale C. Morse, and Jerold L. Zimmerman, Management Accounting (New York: McGraw-Hill, 2001), p. 198

Foreign Operating Unit as a Profit Center

- Treating a foreign operation as a profit centre may not be beneficial for measuring performance if foreign management is not directly accountable for all of the foreign operation's activities.
- The transfer pricing policy of a multinational corporation may be incompatible with the concept of a profit centre.
- When corporate management orders that specific transfer prices be used to meet a specific worldwide cost-minimization goal, the local operation loses authority over profit determination.
- For example, evaluating an assembly plant in a high-tax country as a profit centre would be improper if it is compelled to obtain inputs from overseas affiliates at high rates (dictated by the parent company) in order to avoid worldwide income taxes.
- Some foreign operations have a strategic purpose in addition to generating revenue.
- For example, a corporation may engage in a foreign mining operation in order to have a captive source of a vital raw material.
- The original reason for making this investment was not to make profit, and it should not be judged on that basis.
- Furthermore, if all output is sold (transferred) to affiliated companies, meaning no output is sold on the open market, this operation may have no influence over either sales volume or sales price—both are set by the parent or affiliated customers.
- For this type of organisation, performance may be best measured in terms of cost reduction or productivity rather than profit.
- Furthermore, if the foreign affiliate was founded to sell products manufactured by the parent, perhaps sales volume or market share would be a better performance indicator than profit.
- The crucial issue is that for some international enterprises, evaluating performance on the basis of profitability may not be appropriate.
- Dysfunctional behaviour can develop, for example, if a parent business decides to close down an unprofitable component-parts manufacturing because the parent enforces low transfer pricing.
- Headquarters management must decide which international businesses should be rated as profit centres and which should not.

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Items which are Uncontrollable Items

Uncontrollable things are those that are not under the control of the parent corporation, the host country government, or other parties. The following are some instances of each type:

Parent Company-Controlled Items

- Discretionary transfer pricing determines sales revenue and cost of products sold.
- Allocation of corporate spending to specific operating units, such as the chief executive officer's compensation and research and development costs.
- Interest costs on borrowing from the parent (or a related finance company), which sets the interest rate.

Items under the control of the host government

- Foreign exchange restrictions that limit the supply of imported supplies and parts.
- Limits on the prices that can be charged for goods and services.
- Local content laws, which require component parts to be purchased locally, sometimes at exorbitant prices.

Items Controlled by Others

- Lost production due to labor strikes.
- Lost production due to power outages.
- Losses resulting from war, riots, and terrorism.
- Foreign exchange losses.

When evaluating the foreign operating unit, the decision to adjust the performance measure for uncontrollable elements should be based on whether the item in issue has any impact on cash flows received by the parent from the overseas operation. In general, only goods controlled by the parent should be excluded from the calculation of profit because all other items effect cash flows. For example, while the local manager should not be concerned about lost production as a result of power outages over which he or she has no influence, the cost of lost production should be considered when considering whether to continue with this particular activity.

In contrast, abandoning a specific foreign operation in a high-tax jurisdiction due to inadequate returns would be dysfunctional if the parent's discretionary transfer pricing rules led to the poor ROI.

In terms of whether managers and international operating units should be evaluated on the same basis, organisations typically utilise the same performance measuring tools in evaluating both managers and overseas operating units.

Currency's choice in Measurement of Profit

- It appears that most MNCs evaluate performance, at least partially, on some measure of profitability (net income, profi t margin, return on investment, etc.).
- In using profit for performance evaluation, a major issue that companies must address is whether profit should be measured in local currency or parent company currency.
- If profit is to be measured in parent company currency, the company must select a method of translation and decide whether to include the effects of exchange rate changes.
- Profit is often measured in the local currency if the overseas company is not expected to generate parent currency for dividend payments to stockholders.
- This is true if the activity offers the MNC with a strategic benefit other than the potential to generate parent currency dividends.

- A foreign operation founded specifically to supply raw materials to affiliated enterprises is an example.
- When a foreign subsidiary is expected to generate parent currency that could be given as dividends to stockholders, profits should be measured in the parent currency.
- This is true for the vast majority of foreign subsidiaries.

Foreign Currency Translation

- If parent currency is to be used in performance evaluation, the corporation must translate foreign currency profits into parent currency and choose which translation technique to apply.
- A firm is not required to employ the same translation procedures for internal reasons that it is required to use for financial reporting.
- A multinational corporation headquartered in the United States, for example, is not required to utilise SFAS 52 rules for internal performance evaluation.
- MNCs should think about whether translation approach best reflects economic reality for the specific foreign operation under consideration.

The inclusion of the translation adjustment in the measure of proficiency used for performance evaluation appears to rest on two issues:

1. Does the translation adjustment appropriately reflect the impact of a change in the exchange rate on parent currency cash flows?

2. Is the international operations manager authorised to hedge his or her translation risk?

If you answered yes to both questions, the translation adjustment should be included in the performance evaluation measure, regardless of whether financial reporting rules demand it. If neither question is answered in the affirmative, the translation adjustment in profit may or may not be included.

13.4 Incorporating Economic Exposure into the Budget Process

- Foreign exchange risk can be classified into three types: transaction risk, translation risk (or balance sheet risk), and economic risk.
- The risk that changes in exchange rates will have a detrimental effect on cash flows relating to foreign currency payables and receivables is referred to as transaction exposure.
- Translation exposure refers to the risk that a change in exchange rates may cause the parent firm to record a negative translation adjustment in its consolidated financial statements due to the translation of foreign currency financial statements of its subsidiaries.
- Economic exposure, like transaction exposure, refers to the risk that changes in exchange rates will harm an entity's cash flows.
- However, transaction exposure is only one component of economic exposure. Economic exposure refers to more than just transaction exposure.
- Economic exposure, unlike transaction and translation exposures, is not immediately measured by the accounting system.
- Financial tools such as foreign currency forward contracts and options are frequently used to decrease transaction and translation exposures.
- Making operational and strategic actions to reduce economic exposure make the company more competitive in the face of exchange rate swings.

- Shifting from the usage of imported parts to locally manufactured ones, as well as lowering the local currency pricing in the short term to support export sales, are examples of activities that a corporation could take to lessen economic exposure to exchange rate swings.
- It is difficult to design a control system that allows the parent firm to evaluate the performance of its foreign subsidiary management on their capacity to manage economic exposure while also motivating them to capitalise on opportunities given by exchange rate changes.
- Because economic exposure involves opportunity costs, its consequences are not independently assessed by standard accounting system.
- Consider what can happen if a corporation fails to incorporate economic exposure into its appraisal method.
- Because the accounting system does not evaluate the amount of profit that should have been produced, the information offered by that system is ineffective in assessing a manager's ability to deal with economic risk.
- The application of translation Combinations , which employ expected rates to create the budget, provide a partial answer to this problem.
- Using predicted rates to translate the budget offers an incentive for managers to take operational and strategic initiatives to limit the negative effects of exchange rate changes on cash flows and capitalise on the favourable ones.
- This strategy, however, has limitations in that forecasted exchange rates may not become reality.
- A modification to this approach would be to update the expected ending exchange rate on a regular basis and request that local managers adjust their plans when the prediction changes.
- Clearly, this is not an easy task, but any system that requires managers of international enterprises to evaluate the impact of currency rate fluctuations on their operating performance should be implemented.
- They can assist in lowering the danger connected with them.

13.5 Implementation of a Performance Evaluation System

The success of a performance evaluation system is influenced by both its design and its implementation. The discussion in this part is based on a technical briefing on the latest developments in corporate performance measurement released in 2002 by the Chartered Institute of Management Accountants (CIMA) in the United Kingdom. CIMA identifies six critical characteristics for a good performance evaluation system:

1. Integration with the overall business strategy
2. Feedback and review
3. Comprehensive measures
4. Ownership and support throughout the organization
5. Fair and achievable measures.
6. A simple, clear, and understandable system

Integration with the overall business strategy

It is impossible to measure performance in a meaningful way unless an organization's goals are defined.

For example, if customer service has been identified as a vital success component, then a quick response to complaints may be required to gain a competitive advantage, and a metric such as reaction time can be used to assess performance.

Feedback and review

A constant cycle of feedback on actual results in comparison to the original plan, feeding into the decision-making process, is required for the successful implementation of a performance evaluation system.

It's worth noting that the original plan is predicated on certain assumptions about the nature of the business and what it takes to succeed.

If performance falls short of the expectations set out in the original plan, the organisation can take corrective action.

This is a type of organisational learning known as single-loop learning. The phrase "single-loop" refers to the organization's focus on making decisions inside the confines of the initial plan.

A successful performance evaluation system should also include procedures for periodically reviewing performance measures.

However, it may be necessary to adjust the targets, the activities being measured, or even the objectives.

Double-loop learning is the action engaged in this process.

The emphasis here shifts to a study of the necessity to modify components of the original plan.

Single-loop learning is required to develop core competencies, while double-loop learning is required to adapt to environmental changes.

Comprehensive measures

The performance measuring system should reflect the variety of success variables.

Financial performance, albeit the most essential and generally used measure of performance, represents only one dimension of value and, as such, is insufficient for evaluating an organization's overall strategic performance.

As previously stated in this chapter, MNCs are increasingly using nonfinancial measures to evaluate performance at both the headquarters and subsidiary levels.

Ownership and support throughout the organization

Employees within the organisation must understand and support the performance review system.

If consumers believe the system is being forced from on high, without their input, they are less inclined to work with it, and the system will fail to fulfil its motivational goals.

Fair and achievable measures.

Performance goals should be set at a level that is both achievable and encourages excellent performance.

When performance measurements are used to award managers' performance, fairness is especially crucial.

Performance measurements should only contain variables that managers have direct control over.

If this is not the case, the compensation system is more likely to frustrate and demotivate managers than to push them to perform better.

A simple, clear, and understandable system

The efficiency of a performance evaluation system is mainly determined by how well the people involved comprehend the system and the performance metrics.

There is no value in providing sophisticated data on performance if people being evaluated do not understand it.

If the performance evaluation system is extremely complicated, many people will struggle to understand it. Lack of comprehension will result in a lack of cooperation and support for the system.

It is preferable to utilise simple and obvious measures that everyone in the business can understand and communicate with.

Summary

Accountants contribute to strategy formulation by analysing customer, market, and competition information, assessing risks, developing estimates as financial manifestations of strategy, and preparing budgets. Capital budgeting is a significant tool in strategy development. The numerous risks to which international businesses are exposed complicate multinational capital budgeting. Future cash flows are likely to be influenced by factors such as local inflation, currency fluctuations, and changes in host government policies. Accountants contribute to strategy formulation by analysing customer, market, and competition information, assessing risks, developing estimates as financial manifestations of strategy, and preparing budgets. Capital budgeting is a significant tool in strategy development. The different risks to which international enterprises subject complicate multinational capital are budgeting. Future cash flows are likely to be influenced by factors such as local inflation, currency fluctuations, and changes in host government policies.Companies must choose performance evaluation metrics. Although corporations frequently employ several measurements, both financial and nonfinancial, the majority of them focus on financial measures of success, with profit-based indicators being the most generally utilised.

Keywords

Profit Centre: Profit center implies that profit will be used to determine whether the operating unit is achieving its objectives and that resources will be allocated according to the unit's profit.

Investment Centre: The responsibilities of an investment center manager include all the responsibilities of a profit center manager plus the responsibility for investment decisions.

Financial perspective: refers to the issue of how a firm should appear to its shareholders in order to succeed financially

A balanced scorecard: Combines financial measures of past performance with nonfinancial measures of the drivers of future performance to provide management with a road map for creating shareholder value

Self Assessment

1. …..refers to the issue of how a firm should appear to its customers in order to succeed financially.

A. Financial perspective
B. Internal business process perspective
C. Customer perspective
D. Learning and growth perspective

2. …..refers to how the fi rm will sustain its ability to change and improve in order to achieve its vision

A. Financial perspective
B. Internal business process perspective
C. Customer perspective
D. Learning and growth perspective

3. Which perspective says that in the current environment of rapid technological change, it is becoming necessary for both managers and other employees within a firm to be in a continuous learning mode.
A. Financial perspective
B. Internal business process perspective
C. Customer perspective
D. Learning and growth

4. A balancedscorecard contains performance measures related to
A. Financial perspective
B. Internal business process perspective
C. Customer perspective
D. All the four perspectives.

5. measures of performance that are based on accounting information are:
A. sales growth,
B. cost reduction,
C. profit
D. Host country government

6. …..refers to the business processes at which the fi rm must excel in order to satisfy its shareholders and customers.
a. Financial perspective
b. Internal business process perspective
c. Customer perspective
d. All the four perspectives

7. …..refers to the issue of how a fi rm should appear to its shareholders in order to succeed financially
A. Financial perspective
B. Internal business process perspective
C. Customer perspective
D. All the four perspectives

8. Administrative controls is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

9. Regulatory controls is ….influence?
a. Social
b. Political and legal

c. Technological
d. Economic

10. National economic redevelopment and policies is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

11. Saving Rate is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

12. Employment levels is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

13. Capital availability is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

14. Productivity improvements is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

15. New technologies is ….influence?
A. Social
B. Political and legal
C. Technological
D. Economic

Answers for Self Assessment

1.	C	2.	D	3.	D	4.	D	5.	D

6.	B	7.	A	8.	B	9.	B	10.	D
11.	D	12.	D	13.	C	14.	C	15.	C

Review Questions

1) What are the internal variables that influence strategy formation inside a multinational corporation?
2) What are the external elements that influence strategy creation within a multinational corporation?
3) Describe the function of accounting in strategy building inside a multinational corporation.
4) Contrast the NPV and IRR as capital budgeting strategies.
5) How does an MNC's organisational structure influence strategy implementation?

Further Readings

- International Accounting By Das Mahopatra, Prentice Hall
- International Accounting By Rathore, Shirin, Prentice Hall
- International Financial Management By Jeff Madura
- International Accounting, By Timothy S Doupnik; Hector Perera,Publisher: Mcgraw-Hill Education, Year: 2014, Isbn: 0077862201,9780077862206

Unit 14: Exchange Rate Forecasting

CONTENTS

Objectives

After studying this unit, you will be able to:

- explain the importance of exchange risk forecasting
- explain the various techniques for forecasting the exchange risk

Introduction

Exchange rate forecasting refers to forecasting or predicting/estimating the future exchange rate of a currency in the floating exchange rate regime.It remained an important dimension of multinational financial management in so far as a number of financial decisions, borrowing and lending decisions of MNCs rest on some prediction of the future spot rate of the currency or currencies involved in foreign exchange transactions.The ability of the firm to predict future exchange rates more accurately will have a bearing on its performance in managing the foreign exchange exposure vis-à-vis its overall performance.Besides, MNCs ,financial and non-financial companies like the mutual and hedge fund business find exchange rate forecasting a valuable tool to make speculative gains in the foreign exchange market and enhance shareholder value.

14.1 Importance of Exchange Rate Forecasting

Hedging decision

Financing decision

Investment decision

Evaluating subsidiaries financial performance

Hedging decision

- A firm importing goods from a foreign country will favor market hedge when in the event its forecast rate is higher than the forward rate as this will help the firm to eliminateor minimize the loss due to fluctuations in the exchange rate, which would have resulted in the payment of the higher amount of home currency in the absence of a forward hedge.
- Case analysis:

- HCL India Ltd. imported goods of £50,000 from Chaba Traders of the UK on a three months term at a current exchange rate of 95.3748, and a three months forward rate of 96.5 that will go for the forward contract tobuy £50,000at 96.5 if it estimates the future spot rate to be 97/£, which can help HCL bring its loss down by 21,260 to 60,000 from 81,260 in the absence of a forward contract.
- Is it beneficial for HCL India Ltd. to go in for Exchange Rate Forecasting?

Solution

Amount payable to Chaba Traders UK

£ 50,000 X 97 = 48,50,000

Amount payable to Chaba Traders UK on date of Initiation

£ 50,000 X 95.3748 = 47,68,740

Amount payable in absence of forward contract

48,50,000 - 47,68,740 = 81,260

The calculations clearly indicate that it is beneficial for the firm to go for exchange rate forecasting.

Financing Decision

- A firm borrowing in foreign currency as a part of its capital structure decision will find it beneficial to borrow in such currencies whose value is expected to fall over maturity, i.e. home currency becomesstronger compared to the foreign currency in context, resulting in the borrowing firm paying less to settle the debt; the resultant effect is a reduced repayment burden on the part of the borrowing firm.
- JK India Ltd. is contemplating raising 45,00,000 overseas on a three years term and has shortlisted five countries whose current and forecasted exchange rates are given in the upcoming slide.

• Country	• US	• UK	• Australia	• Canada	• Japan
• Current rate	• 45/$	• 68/£	• 40/$	• 35/$	• 30/¥
• Forecasted rate	• 44/$	• 67/95$	• 42/$	• 38/$	• 34/¥

It can be beneficial for JK India Ltd. to go for borrowing in USD. The firm, therefore, will borrow

45,00,000/ 45 = 1,00,000 USD at present, for which it will be required to pay off, at the time of redemption 44,00,000, which is lesser by 1,00,000 to settle the debt.

- A foreign currency forecast will, therefore, be advantageous to the company trying to design its capital structure and financial activities.

Investment Decision

- Investment decisions of the MNCs, both short- term and long-term, get influenced by the forecasted exchange rates. For example, MNCs park their surplus cash into short-term investments in
- different foreign currency whose forecasted future spot rates are higher than the forward rate, as this will maximize their earnings.
- The long-term investment decisions of the MNCs to get guided by similar principles as long as the cash inflows are the maximum.

Evaluation of the subsidiaries financial performance

- Earnings of the subsidiaries expressed in forecasted exchange rates will enable the MNCs to evaluate the subsidiaries' performance better. .
- The forecasted exchange rate too will help the MNCs decide the direction and magnitude of their foreign investments.
- They will like to invest in countries whose currencies are expected to appreciate against the home currency as this will result in an enhanced inflow of cash.

14.2 Techniques of Exchange Rate Forecasting

Broadly categorized as:

1. Pure Forecasting
2. Economic Structural models
3. Technical Forecasting
4. Market-based Forecasting

Technical Forecasting:

- It is useful for short for short-term forecasting and for intending to make profits quickly.
- Suffers from the limitation that it depends on a single factor, historical rate alone, ignoring many other macroeconomic factors.
- Despite this shortcoming, it is still a dominant technique followed among professional forecasters.
- Under it, the future spot rate of exchange is forecasted by fitting the historical rates of exchange into:
- Simple charts - line chart, bar chart and Cylindrical/Candle Stick Chart etc.

Moving Average

- In finance, a moving average (MA) is a stock indicator commonly used in technical analysis.
- The reason for calculating the moving average of a stock is to help smooth out the price data by creating a constantly updated average price.
- By calculating the moving average, the impacts of random, short-term fluctuations on the price of a stock over a specified time frame are mitigated.
- A moving average (MA) is a stock indicator commonly used in technical analysis.
- The moving average helps to level the price data over a specified period by creating a constantly updated average price.
- A simple moving average (SMA) is a calculation that takes the arithmetic mean of a given set of prices over a specific number of days in the past.
- An exponential moving average (EMA) is a weighted average that gives greater importance to the price of a stock in more recent days, making it an indicator that is more responsive to new information.
- Statistical and Operation Research tools like Moving average – simple and weighted; linear regression, and other autoregressive model
- The use of historical exchange rate data to anticipate future values is known as technical forecasting.
- There could be a tendency of consecutive daily exchange rate adjustments in the same direction, which could lead to the trend continuing.
- Alternatively, there may be certain technical evidence that an exchange rate correction is imminent, resulting in a projection that the exchange rate will reverse its direction.

Technical Forecasting Limitations

- Technical forecasting is used only infrequently by multinational organisations since it often focuses on the immediate future, which is ineffective for formulating company policy.
- The majority of technical forecasts apply to relatively short-term periods (for example, one day) because trends in exchange rate movements may be more predictable during such time spans.
- Technical forecasts are less useful for anticipating exchange rates in the distant future since such patterns are likely less trustworthy for forecasting long-term movements (for example, over a quarter, a year, or five years).
- As a result, technical forecasting may not be appropriate for organisations that require a long-term projection of exchange rates.

Market-based Forecasting

It operates on the present spot rate and presents the forward rate along with the forecasters' expectation of a rise or fall in the future spot rate of foreign currency.

Example for Market-based Forecasting:

Exchange rate of USD over the six months is given below:

Months	April	May	June	July	August	September
Current Rate	79/$	78/$	79/$	79.5$	80/$	82.5/$

The dollar is expected to appreciate by 13% over the next quarter. Calculate the exchange rate in November 2022.

Average spot rate during the given months = 79+78+79+79.5+80+82.5/6= 79.66/$ or 80/$

Exchange rate in November shall be (79.66/$ or 80/$) X 1.13 = 90.0158/$ or 90.4/$

This method of forecasting, like technical forecasting, is also beneficial for speculators in the short run.

For long-term forecasting, interest rate parity theory may be applied, stating that if the interest rate of a country appreciates, its currency will depreciate.

The value of currency appreciation or depreciation, for example, Indian Rupay and Japanese Yen, can be calculated as:

I stands for Interest rate and n is number of years to forecast

$$[(1 + I_{India})^n/(1 + I_{Japan})^n] - 1$$

Suppose the current rate in India is 11%, and in Japan, it is 60%. What will be the exchange rate of the rupee against the yen 2 years down the line if the current exchange rate is 32/¥?

Formula:

= 9.6%

Exchange rate will be 32+9.6 = 35.07/¥

$$[(1 + I_{India})^n/(1 + I_{Japan})^n] - 1$$

Fundamental Forecasting

- Considers a number of macroeconomics variables while estimating future spot rate of exchange.
- Variables can be Inflation, exchange rate etc.
- Suppose future spot rate in nth year =
- [(Current spot rate) X {(1+% of Inflation in Home Country)/(1+%of Inflation in Host Country)}n

S0 , S1 and S2 are the sensitivity of variables determined through regression equations and are error terms.

Limitations of fundamental forecasting

Underlying forecasting, although accounting for the expected fundamental linkages between components and currency values, has four major limitations:

1. The precise timing of the impact of various events on the value of a currency is unknown. It's likely that the entire influence of factors on exchange rates won't be felt for two, three, or four quarters. The regression model would have to be changed as a result.
2. As previously stated, several factors have an immediate impact on exchange rates. However, such aspects can only be advantageously included in a fundamental forecasting model if projections for them can be generated. These projections should be generated for the time period for which an exchange rate forecast is required. In this scenario, the accuracy of these parameters influences the accuracy of the exchange rate forecasts. Even if a corporation understands exactly how its movements affect currency rates, its exchange rate estimates may be wrong if the factors' values cannot be predicted.
3. Some aspects that should be included in the fundamental forecasting process are difficult to quantify. Assume that huge Chinese exporting enterprises face an unexpected labour strike that generates shortages. This will restrict the availability of Chinese goods for Australian customers, and thus the demand for Chinese yuan in Australia. Such an event, which would put downward pressure on the value of the Chinese yuan, is not generally factored into a forecasting model.

Mixed forecasting

Covers the limitation of individual forecasting techniques that consider individual rates by assigning weights to a maximum of the unit or one to the forecasted rates.

Given the exchange rate under technical, market based and fundamental forecasting as 44/$, 47.25/$, 49.50/$, what will be the rate under mixed forecasting?

Rate under mixed forecasting will be =

(44/$ X 0.2)+(47.25/$ X 0.3) + (49.50/$ X 0.5) = 47.73/$

Forecasts of the Chinese yuan drawn from each forecasting technique

Forecast technique	Factors considered	Situation	Forecast
Technical	Recent movement in yuan	The yuan's value declined below a specific threshold level in the last few weeks.	The yuan's value will continue to fall now that it is beyond the threshold level.
Fundamental	Economic growth, inflation, interest rates	China's interest rates are high, and inflation should remain low.	The yuan's value will rise as Australian investors capitalise on the high interest rates by investing in Chinese securities.
Market-based	Spot rate, forward rate	The yuan's forward rate exhibits a significant discount, which is attributed to China's relatively high interest rates.	Based on the forward rate, which provides a forecast of the future spot rate, the yuan's value will decline.

14.3 Evaluation of Forecasting Performance

Regardless of the method or service used to estimate currency rates, it is critical to understand that forecasted exchange prices are rarely correct.

Multinational firms frequently analyse the accuracy of their forecasting processes by analysing historical forecast errors.

Forecasting strategies can be evaluated by comparing actual currency values to those projected by the forecasting approach.

This comparison should be undertaken over numerous time periods to be useful.

The bias and accuracy criteria are used to evaluate the performance of a forecast method.

When comparing forecast accuracy for two currencies, the absolute forecast error should be divided by the currency's realised value to account for changes in the currencies' relative values.

Measurement of forecast error

- A multinational corporation that forecasts exchange rates must track its performance over time to evaluate whether the forecasting technique is adequate.
- A forecast error measurement is required for this purpose. Forecast errors can be calculated in a variety of ways.
- One prominent metric is discussed in this section and is defined as follows:
- Absolute forecast error as a percentage of the realised value= $\frac{|\text{Forecasted value} - \text{Realised value}|}{\text{Realised value}}$
- The error is calculated using an absolute value (in the numerator) to avoid an offsetting impact when calculating the mean prediction error.
- For example, if the forecast error is 0.05 in the first period and 0.05 in the second (assuming no absolute value is used), the mean error is zero.
- That, however, would be misleading because the prognosis was not perfect in either era. Using the absolute value avoids such distortions.
- Examine the proportional amount of the difference between the anticipated value and the realised value when comparing the performance of a forecasting technique across different currencies.

Forecast errors vary throughout time horizons.

- The possible forecast inaccuracy for a specific currency is determined by the forecast horizon.

- A projection of the New Zealand dollar spot rate for tomorrow will have a reasonably small inaccuracy since the spot rate tomorrow is unlikely to change significantly from today's.
- A one-month projection of the New Zealand dollar, on the other hand, is more challenging because there is more time for economic conditions to change, causing the New Zealand dollar's value to deviate farther from today's current rate.
- A one-year projection of the New Zealand dollar is considerably more challenging, and a 10-year prognosis will almost certainly be subject to significant error.

Forecasting errors across time

The forecast error for a certain currency varies over time.

When a country is suffering economic and political difficulties, its currency becomes more volatile and difficult to predict.

The size of the inaccuracies varies with time since the errors are bigger when the value of the currency is more volatile.

Currency forecasting errors

The capacity to forecast currency values varies depending on the currency under consideration.

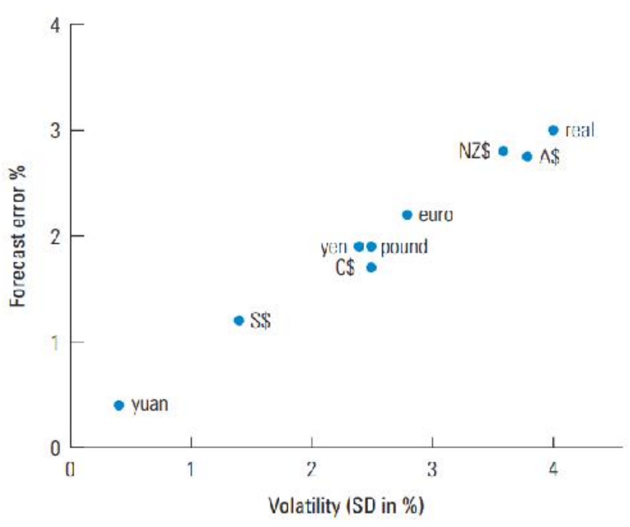
From an Australian perspective, more stable currencies are less prone to error.

For an extreme example, if a currency's value is fixed to an identical Australian dollar level, the spot rate is always a flawless forecast of the future spot rate, with 0% forecast error.

The Chinese central bank keeps the value of the Chinese yuan within restricted parameters, therefore the yuan is relatively steady and should have a reduced forecast error.

In contrast, volatile currencies (such as the Australian dollar, Brazilian real, and New Zealand dollar) should have bigger forecast errors.

How forecast error is affected by volatility



Source: International financial management by Jeff Madura

The Figure shows the results of correlating the mean absolute forecast error to volatility (standard deviation of exchange rate movements) for selected currencies; the points are drawn using monthly data from 2007 to 2012.

The monthly forecasts for each currency were calculated using the currency's current spot rate as the one-month forecast.

The graph shows how forecast errors are smaller for less volatile currencies, such as the Chinese yuan and Singapore dollar (S$), and greater for more volatile currencies, such as the Australian dollar (A$), Brazilian real, and New Zealand dollar (NZ$).

Financial managers of MNCs should be especially concerned if they are Financial managers of MNCs should be especially concerned if they are exposed to these more volatile currencies because they are subject to greater forecast errors.

As a result, managers may desire to hedge that risk.

Forecast bias

When a forecast error is calculated as the anticipated value minus the actual value, negative errors indicate underestimation and positive errors indicate overestimation.

If forecast errors for a given currency are consistently positive or negative over time, then the forecasting technique must be biased.

Graphical evaluation of forecast bias

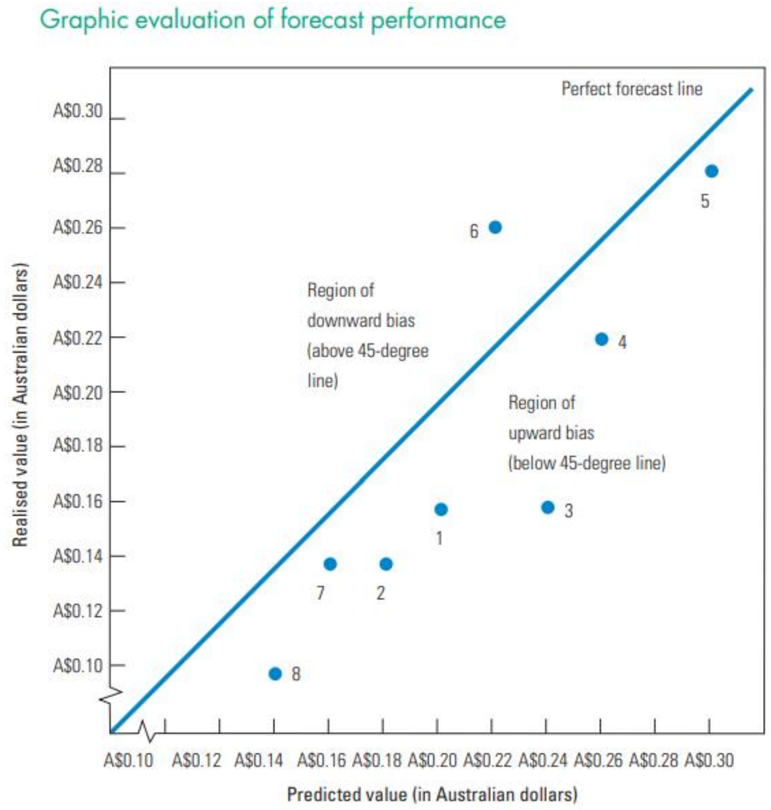
Forecast bias can be investigated using a graph that compares forecasted values with actual values over various time periods.

If the points appear to be evenly distributed on both sides of the 45-degree line, the forecasts are said to be unbiased because they do not routinely exceed or fall below the realised values.

When measuring the extent of forecast mistakes or looking for a bias, examining a large number of forecasts yields more reliable results.

Evaluation of forecast performance

Period	Predicted value of Currency Q for end of period	Realised value of Currency Q at end of period
1	A$0.20	A$0.16
2	A$0.18	A$0.14
3	A$0.24	A$0.16
4	A$0.26	A$0.22
5	A$0.30	A$0.28
6	A$0.22	A$0.26
7	A$0.16	A$0.14
8	A$0.14	A$0.10



Source: International financial management by Jeff Madura

Summary

Exchange rate swings effect both the cost of an MNC's operations and its revenue. As a result, an MNC's estimates of currency rate swings might alter the feasibility of planned initiatives and influence managerial decisions. Any change in exchange rate estimates can affect the relative benefits of alternative proposed operations, causing the MNC to rethink its business strategies.Exchange rate forecasts are **quarterly estimations of the future levels of exchange rates over the next four quarters**. They are undertaken by economists and currency analysts working for portfolio management firms and investment banks.Economists and investors always tend to forecast future exchange rates so that they can depend on the predictions to derive monetary value. Different models are used to determine a currency's future exchange rate.Exchange Rate Forecasts are derived by the computation of the value vis-à-vis other foreign currencies for a definite period. There are numerous theories to predict exchange rates, but they all have limitations.However, as with predictions, almost all of these models are full of complexities, and none of these can claim to be 100% effective in deriving the exact future exchange rate.

Keywords

Technical forecasting: The use of historical exchange rate data to anticipate future values is known as technical forecasting.

Fundamental forecasting: Fundamental forecasting is based on fundamental economic indicators and exchange rates.

sensitivity analysis: A technique for assessing uncertainty in which several options are entered to predict possible outcomes.

Mixed forecasting: Because no single forecasting technique has been found to be consistently better than the others, some multinational corporations (MNCs) prefer to use a blend of forecasting techniques. This strategy is known as mixed forecasting

Self Assessment

1. …..the main technique used by investors who speculate in the foreign exchange market, especially when their investment is for a very short time period.

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

2. ……is a forecast where from a subjective assessment of the degree to which general movements in economic variables in one country are expected to affect exchange rates

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

3. Sensitivity analysis is used in….

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

4. Theory of purchasing power parity can be used in…..

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

5. The process of developing forecasts from market indicators…..

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

6. ….is usually based on either the spot rate or the forward rate.

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

7. The techniques used are assigned relative weights that total 100 per cent, with the techniques considered more reliable being assigned higher weights.

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting

D. Market –based forecasting

8. The actual forecast of the currency is a weighted average of the various forecasts developed.
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

9. In …..forecasting, if the international Fisher effect holds, then a currency with a higher quoted (nominal) interest rate than the Australian interest rate should depreciate against the Australian dollar
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

10. The precise timing of the impact of some factors on a currency's value is not known. It is possible that the full impact of factors on exchange rates will not occur until two, three or four quarters later. This is a limitation of …..
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

11. Coefficients derived from the regression analysis may not remain constant over time. This is a limitation of …..
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

12. The effect of unanticipated labour strike that causes shortages can-not be quantified. This is a limitation of …..
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

13. Although the inflation differential by itself is not sufficient to accurately forecast exchange rate movements, it should be included in any……
A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

14. To forecast the yuan's percentage change over the upcoming period, both Interest and Inflation must be estimated. This is an example of:

A. Fundamental forecasting
B. Technical forecasting
C. Mixed forecasting
D. Market –based forecasting

15. Multinational corporations make only limited use of ….. forecasting because it typically focuses on the near future, which is not that helpful for developing corporate policies

A. Technical forecasting
B. Fundamental forecasting
C. Mixed forecasting
D. Market –based forecasting

Answers for Self Assessment

l.	A	2.	B	3.	B	4.	B	5.	C
6.	C	7.	C	8.	C	9.	D	10.	B
11.	B	12.	B	13.	B	14.	A	15.	A

Review Questions

1. Explain why corporations forecast exchange rates.
2. Describe the method for anticipating exchange rates. What are some of the drawbacks of utilising technical forecasting to forecast exchange rates?
3. Explain the basic method for anticipating exchange rates. What are some of the drawbacks of forecasting exchange rates using a fundamental technique?
4. Describe the market-based method for anticipating exchange rates. What is the reasoning behind employing market-based forecasts?
5. Explain the mixed forecasting technique for currency rates.

Further Readings

- International Accounting By Das Mahopatra, Prentice Hall
- International Accounting By Rathore, Shirin, Prentice Hall
- International Financial Management By Jeff Madura

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