NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: ACC 426

COURSE TITLE: INTERNATIONAL ACCOUNTING SYSTEM

INTERNATIONAL ACCOUNTING SYSTEM

ACC426

Course Guide

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CONTENT

INTRODUCTION

You are holding in your hand the course guide to ACC426 (International Accounting System). The purpose of the course guide is to relate to you the basic structure of the course material you are expected to study as an Accounting Student in National Open University of Nigeria. Like the name 'course guide' implies, it is to guide you on what to expect from the course material and at the end of studying the course material.

COURSE CONTENT

The course content basically focuses on International Accounting System. The course material tends to portray accounting with global dimension of its implication in modern realities. As the world becomes a global village, the need to harmonize accounting standards becomes more intense, so as to facilitate mutual understanding and cooperation among nations.

Multinational corporations have become the vehicles of global drives. The course material has successfully dealt with issues relating to multinational corporations. In the light of that, the course material has richly dealt with issues such as performance evaluation, foreign currency issues, international taxation and transfer pricing.

COURSE AIM

The aim of the course is to bring to your cognizance the practice of accounting with its international dimension in recent times.

COURSE OBJECTIVES

At the end of studying the course material, among other objectives, you should be able to:

1. Discuss how accounting is shaped by its environment.
2. Explain the international market in relation to accounting services.
3. State the various possible forms of organization that international aspects have been integrated into financial management.
4. Discuss external finance as a factor influencing accounting development.
5. Discuss legal system as a factor influencing accounting development.
6. Discuss political and economic ties with other countries as a factor influencing accounting development.
7. Discuss the levels of inflation as a factor influencing accounting development.
8. Discuss size and complexity of business enterprises, sophistication of management and financial community and general levels of education as factors that influence accounting development.
9. List and describe the three accounting models.

10. Discuss some existing financial accounting practice differences using goodwill, income smoothing and asset valuation.
11. Explain the opinion of corporate management, investors, stock markets and regulators and accounting professionals and standard setters regarding international accounting diversity.
12. Distinguish between financial and nonfinancial disclosure.
13. Explain the bases used for ensuring disclosure.
14. Discuss the following:
    a. Segment disclosure
    b. Financial forecast disclosures
    c. Information about shares and shareholders disclosure
15. Explain the purposes of accounting and auditing standards and how they are related.
16. List and explain the benefits of accounting harmonization.
17. List and explain the barriers to accounting harmonization
18. State the objectives of IASC.
19. State the obligations member countries of IASC are expected to do to support the objectives of IASC.
20. List and discuss the operating structure of IASC.
21. Describe the operating procedures of IASC for setting up accounting standards.
22. Describe how the approval for the IASC restructuring was obtained.
23. Explain what the key responsibilities of IASB are.
24. State the specific objectives of IASB
25. Explain the IASB due process.
26. Discuss the qualification of IASB members.
27. Discuss the Standard Advisory Council.
28. Discuss the International Financial Reporting Interpretations Committee
29. State the benefits of global accounting standards.
30. State the justification for having international standard setters.
31. State the recent trends in International Financial Reporting Standards
32. Define transnational financial reporting and explain what has caused the phenomenon.

33. Discuss problems confronting users of foreign financial statements.
34. State and explain what multinational corporations do to accommodate foreign readers of their financial reports.
35. Discuss what it means to translate a financial statement item at the historical exchange rate.
36. Discuss what it means to translate items in the financial statement at the current exchange rate.
37. Discuss the methods of taxation.
38. Discuss classical versus integration system of taxation
39. Explain who is subject to tax.
40. Explain the determination of tax base and rates.
41. Explain tax credit, tax treaties, tax havens, deferral principle and tax exemption.
42. State the procedures in minimizing and avoidance of tax in a tax planning information system.

COURSE MATERIAL

The course material package is composed of:

The Course Guide

The study units

Self-Assessment Exercises

Tutor Marked Assignment

References/Further Reading

THE STUDY UNITS

The study units are as listed below:

MODULE 1: GLOBALIZATION OF ACCOUNTING

Unit 1: Financial Accounting with International Perspective

Unit 2: Factors Influencing Accounting Development

Unit 3: Diversity in Financial Accounting Practices

Unit 4: Global Assessment of Disclosure Practices

MODULE 2: **ACCOUNTING HARMONIZATION**

Unit 1: Promotion of International Accounting Harmonization

Unit 2: International Accounting Standards Committee

Unit 3: International Financial Reporting Standards

Unit 4: Financial Reporting in the International Environment

MODULE 3: **ISSUES WITH MULTINATIONAL CORPORATIONS**

Unit 1: The Multinational Corporations

Unit 2: International Financial Statement Analysis

Unit 3: Information Systems for Multinational Planning and Control

Unit 4: Multinational Budgeting

Unit 5: Multinational Control Systems

MODULE 4: **PERFORMANCE EVALUATION AND FOREIGN CURRENCY ISSUES**

Unit 1: Performance Evaluation in MNCs

Unit 2: Issues to Consider when Developing MNC Evaluation Systems

Unit 3: Foreign Currency Translation

Unit 4: Translation Methods

MODULE 5: INTERNATIONAL TAXATION AND TRANSFER PRICING

Unit 1: International Taxation

Unit 2: United States Taxation of a Foreign Corporation

Unit 3: Multinational Transfer Pricing

ASSIGNMENTS

Each unit of the course has a self assessment exercise. You will be expected to attempt them as this will enable you understand the content of the unit.

TUTOR MARKED ASSIGNMENT

The Tutor Marked Assignments (TMAs) at the end of each unit are designed to test your understanding and application of the concepts learned. Besides the preparatory TMAs in the course material to test what has been learnt, it is important that you know that at the end of the course, you must have done your examinable TMAs as they fall due, which are marked electronically. They make up 30 percent of the total score for the course.

SUMMARY

International accounting system as a course in accounting is a giant stride towards actualizing the global demand of understanding and cooperating on financial matters in recent times. The world is no doubt a global village with the technological advancement we celebrate today. Financial transactions have equally played a crucial role in these global realities. Therefore, it is very important that you commit adequate effort to the study of the course material for maximum benefit.

INTERNATIONAL ACCOUNTING SYSTEM

ACC426

MAIN CONTENT

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MODULE 1: GLOBALIZATION OF ACCOUNTING

UNIT 1: FINANCIAL ACCOUNTING WITH INTERNATIONAL PERSPECTIVE

CONTENT

1.0 INTRODUCTION

Financial accounting information is oriented primarily toward those users external to the business enterprise who provided capital used in establishing the business. Hence, financial accounting is defined as the classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation by means of profit and loss account, balance sheet and cash flow statements during and at the end of an accounting period (CIMA). Those who have money to invest or lend may decide where to invest such resources based on the financial accounting information available to them about such prospective companies. Basically, accounting satisfies the need for information.

2.0 OBJECTIVES

After studying this unit, you should be able to

43. Discuss how accounting is shaped by its environment.
44. Explain the international market in relation to accounting services.
45. State the various possible forms of organization that international aspects have been integrated into financial management.

3.0 MAIN CONTENT

3.1 ACCOUNTING AND THE ENVIRONMENT

Environment is a fundamental factor that determines the development of any phenomenon. Discussing an international accounting system primarily connotes accounting in different types of environment. Just as nations differ in their histories, values and political systems, they also have different patterns of financial accounting development. For example, accounting as studied by students in the United States is not the same accounting that students in other nations study (Gernon/Meek 2001).

The difference is an outgrowth of the variety of business environments around the world and the fact that accounting is shaped by the environment in which it exists. It follows therefore, that when nations' business environments are similar; their financial accounting systems also tend to be similar. Moreover, as national economies become more interdependent and converge into a global economy, so also there is some convergence of accounting around the world.

One basic environment that shapes the development of financial accounting information is the purpose to which it was prepared. Like was stated in the introduction of this unit, that financial accounting is oriented primarily toward those users external to the business enterprise who provided capital used in establishing the business, in many countries, such as the United States, financial accounting information is directed primarily towards the needs of shareholders and those who would make use of the financial accounting information for decision making purposes. However, for some countries, financial accounting is designed primarily to ensure that the proper amount of income tax is collected by the government. While in some other countries, financial accounting is designed to help accomplish macro-economic policies, such as achieving a predetermined rate of growth in the nation's economy.

SELF ASSESSMENT EXERCISE
Accounting is shaped by the environment it exist, discuss.

3.2 GLOBAL MARKET AND FINANCIAL SERVICES

Much has been said and written about the multinational nature of today's world economy. All kinds of automobiles, electronics and all sorts of products are commonplace worldwide, available where they were not originally manufactured. This expresses global economic interdependence. Business enterprises are the main carriers of economic internationalism. Most of today's larger corporations can be characterized as multinational. According to David E. Lilienthal, multinational corporations are corporations which have their home in one country but operate and live under the laws and customs of other countries as well.

Corporate internationalism takes many forms. For example, many components of a final product assembled in South Africa may in fact be manufactured in the United States. That is, individual parts of consumer goods like cars, personal computers, and television set, routinely originate in countries outside the final assembly location.

Another dimension of corporate internationalism is manifest in cross-border business mergers and acquisitions. For example, highly visible 1989 events include the acquisition of a controlling interest in New York's Rockefeller Centre by a group of Japanese investors.

Yet another dimension of corporate internationalism comes about through truly global markets for corporate securities. Records for off-shore purchases of corporate securities were set in the second quarter of 1989, according to the US Securities Industry Association. During that quarter US investors purchased a net of $4.4 billion of foreign securities. During the same quarter, net purchases of US stocks by foreign investors rose to $4.5 billion – (total buying and selling of US equities by foreign investors during the second quarter of 1989 amounted to $107).

On the other hand, it is important you note that professional accounting services are also delivered on an international scale. Such services include the independent audit of financial statements prepared by management, tax research and consulting, and information systems design. Professional accounting services firms range from single individuals to gigantic multinational partnerships. Since substantial business activities and professional accounting service activities are devoted to international organizations, it is obvious that accounting as a professional field and as an intellectual discipline is internationalized as well.

SELF ASSESSMENT EXERCISE
Do you agree that professional accounting service is internationalized? Substantiate your opinion.

3.3 Organization of Management Information System

Some years ago, chief financial officers of larger companies needed to know little about international business and finance. Today, according to a survey by one executive recruiting firm, almost half of all senior financial executive positions to be filled demands thorough familiarity with international dimensions of business. International aspects have been integrated into financial management in general.

Such integration, however, may occur in any one of several possible forms of organization. Some companies organize all of their international business into a single division, which then parallels a number of domestic divisions. Other companies create product lines; each autonomously organized to do domestic as well as international business. Still others employ a functional organizational format. Here such business functions as production, marketing, research and development, finance and accounting are integrated into worldwide units to perform all corporate activities specifically charged to each function.

Organizational difficulties arise when management information systems are not structured in parallel with the organization as a whole. For example, if a firm is recognized according to product lines of business, the prevailing management information system should not be functionalized within a worldwide accounting unit. Otherwise you have a corporate financial executive function with most of the accounting staff working for product line organizations. Such disparity is likely to cause major inefficiencies and ineffectiveness for the prevailing management information system and possibly destroy its validity altogether.

An equally difficult problem relates to the type of management information system best suited for multinational business operations. Should there be two systems- one for domestic operations and one for international purposes? Does management need the same type of decision- relevant information both at home and abroad? What is the best language to use for worldwide operations? Should managers in different countries get different information for local decision-making purposes? It stands to reason that major communications problems must be resolved when these types of questions are addressed.

SELF ASSESSMENT EXERCISE
Familiarization of international business dimension is essential for effective management. Discuss.

4.0 CONCLUSION

Accounting is often referred to as the language of business. One of the languages that accounting must 'speak' is international. Business enterprises are the main carriers of economic internationalism. Most of today's larger corporations can be characterized as multinational. The international dimensions of business have resulted in the internationalization of accounting. This is because accounting basic goal is to provide information needed by external users of a business entity. Since substantial business activities and professional accounting service activities are committed to international organizations, it is only a consequence that accounting as a professional field and as an intellectual discipline is internationalized as well.

5.0 SUMMARY

In this unit, we discussed the topic financial accounting with international perspective. This was discussed in three sub-units which are accounting and the environment; global market and financial services; and organization of management information systems.

You would recall that environment is a fundamental factor that determines the development of any phenomenon. Discussing an international accounting system primarily connotes accounting in different environment. Most of today's larger corporations can be characterized as multinational. And accounting as a result of business metamorphosis has equally been internationalized.

6.0 TUTOR MARKED ASSIGNMENT

1. International accounting system primarily connotes accounting in different types of environment. Discuss.

2. State the various forms, corporate internationalism takes.

3. State the various possible forms of organization that international aspects have been integrated into financial management.

7.0 REFERENCES/FURTHER READING

Davidson, R. A., Gerlardi, A. M. G., and Li, F (1996), "Analysis of the Conceptual Framework of China's New Accounting System". Accounting Horizons, pp58 – 74.

Gernon, H. and Meek, G. K. (2001), *Accounting, An International Perspective*, New York: McGraw-Hill Higher Education.

Gernon, H. and Wallace, R. S. O. (1995)," International Accounting Research: A Review of Its Ecology, Contending Theories and Methodology". Journal of Accounting Literature 14, pp 54 – 106.

Mueller, G. G., Gernon, H. and Meek, G. (1991), *Accounting, An International Perspective*, Homewood: Irwin Richard D.

MODULE 1: GLOBALIZATION OF ACCOUNTING

UNIT 2: FACTORS INFLUENCING ACCOUNTING DEVELOPMENT

CONTENT

1.0 INTRODUCTION

Like was stated in unit 1, environment is a fundamental factor that determines the development of any phenomenon. International accounting system primarily connotes accounting in different types of environment. Just as nations differ in their histories, values and political systems, they also have different patterns of financial accounting development. Basically, this environment is expressed by shaping factors that influence the development of accounting. Therefore, it is in the light of this unit to discuss further those factors that influence accounting development.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Discuss external finance as a factor influencing accounting development.
2. Discuss legal system as a factor influencing accounting development.
3. Discuss political and economic ties with other countries as a factor influencing accounting development.

4. Discuss the levels of inflation as a factor influencing accounting development.

5. Discuss size and complexity of business enterprises, sophistication of management and financial community and general levels of education as factors that influence accounting development.

3.0 MAIN CONTENT

3.1 EXTERNAL FINANCE

In situation where a company grows from private ownership to public ownership due to the need for capital increase, the first observation is that the shareholder group become large and diverse. The second observation is that ownership is separated from management. Owners of the business (shareholders) become essentially uninvolved in the day-to-day management of the companies they owned. In such situation, in order to know how well a company is doing, financial accounting information becomes an important source of information. This was how the industrial revolution in the United States and Britain aided the development of accounting.

Another point in external financing is the credit system. Where banks are primarily the source of capital, financial accounting is oriented toward creditor protection. There are close ties between companies and banks. The information needs of the resource providers are satisfied in a relatively straightforward way through personal contacts and direct visits. Since the business enterprises have to deal with only a few creditors and sometimes even one, direct access in an efficient and practical way to have the company's financial health monitored. Another consideration in external financing is to what extent the government gets involved in company investment. Like in France and Sweden where the National Governments play a strong role in managing the countries resources and business enterprises are expected to accomplish the governments' policies and macro-economic plans. Governments also actively ensure that businesses have adequate capital and will lend or even invest in companies if necessary. Financial accounting is oriented toward decision making by government planners. Firms follow uniform accounting procedures and reporting practices, which facilitate better government decisions.

Finally, the relationship between a company and provider of capital changes when new capital is secured from international financial markets means that the information demands of both domestic and international sources of finance must be satisfied. This would call for going beyond domestic expectations and customs in providing financial reports.

SELF ASSESSMENT EXERCISE
What is the effect of capital increase on shareholders?

3.2 LEGAL SYSTEM

A major factor that influences the development of accounting is the legal system that operates in that country. Many dissect the accounting world into those countries with a 'legalistic' orientation toward accounting and those with a 'non legalistic' orientation. They explained that the legalistic approach to accounting is predominantly represented by the so called code law countries while the non-legalistic approach is the so-called common law countries.

Laws in code law countries stipulate the minimum standard of behaviour expected. Citizens are obligated to comply with the letter of the law. In most code law countries, accounting principles are codified much as the tax code is in the United States. Thus, financial accounting is administered government bodies. Accounting practices and rules tend to be highly prescriptive, detailed and procedural. A primary role of financial accounting in these countries is to determine how much income tax a company owes the government. For example, such countries are Argentina, France and Germany.

The non-legalistic approach found in common law countries establishes the limits beyond which it is illegal to venture. However, within this limits, latitude and judgment are permitted and encouraged. Accounting practices in common law countries are largely determined by accountants in the private sector and they evolve by becoming commonly accepted in practice. Thus, accounting tends to be more adaptive and innovative. Examples of common law countries that adopt non-legalistic approach are the United States and the United Kingdom.

SELF ASSESSMENT EXERCISE
Distinguish between a legalistic orientation and non-legalistic orientation.

3.3 POLITICAL AND ECONOMIC TIES WITH OTHER COUNTRIES

One factor that has shaped accounting development is the political and economic ties that exist among nations. The United States has influenced accounting in Canada due to geographic proximity and friendly economic ties and because a number of Canadian companies routinely sell shares of common stock or borrow money in the United States. The United States is Mexico's principal trading partner: and also because of proximity, accounting in Mexico is very much like that in the United States.

Another significant force in international accounting has been the United Kingdom. Almost every former British colony has an accounting profession and financial accounting practices patterned after the UK model. These countries include Australia, New Zealand, Malaysia, Pakistan, India, South Africa and Nigeria. The British did not only export their brand of accounting but also exported many accountants. Most early US accountants also came from Britain, seeking the job opportunities associated with the economic expansion that was occurring in the United States around the turn of the 20th century.

The political and economic ties among nations have forced accounting practices to become more similar. Consequently, this has led to the rise of the International Accounting Standards Committee (IASC) which has become the driving force globally to develop international financial accounting standards and sought for their widest possible acceptance and use. Similarly, the International Federation of Accountants Committee (IFAC), among many other activities, develops and issues international auditing standards which were accepted in 1992 for financial reporting in international financial market.

SELF ASSESSMENT EXERCISE
How did United State influence the accounting development in Canada?

3.4 LEVEL OF INFLATION

Another factor that influences the development of accounting is the level of inflation. Accounting in many countries is based on the historical cost principle. The principle is based on an assumption that the currency unit used to report financial results is reasonably stable. The historical cost principle holds that originally record transactions at prices when they occurred and make no changes to these prices later on. Generally, historical cost principle affects accounting most significantly in the area of assets values that the company keeps for a long time such as land and buildings. The reasonableness of the historical cost principle varies inversely with the level of inflation.

Germany and Japan hold strictly to historical cost principle because they have historically experienced very little inflation. However, some South American countries, ravaged by inflation problem for years, long age abandoned any attachment to strict historical cost. Companies in these countries routinely write up the values of their assets based on changes in general price levels.

SELF ASSESSMENT EXERCISE
Describe how the level of inflation influences the development of accounting.

3.5 SIZE AND COMPLEXITY OF BUSINESS ENTERPRISES, SOPHISTICATION OF MANAGEMENT AND THE FINANCIAL COMMUNITY, AND GENERAL LEVELS OF EDUCATION

These factors define the limits of a country's accounting sophistication. Larger, more complex business enterprises have more difficult accounting problems. Highly trained accountant are needed to handle these more difficult problems; accounting cannot be highly developed in a country where general education levels are low, unless that country imports accounting talent or sends bright citizens elsewhere for the necessary training. At the same time, the users of a company's financial reports must themselves be sophisticated- or else there will be no demand for sophisticated accounting reports.

Most multinational corporations are headquartered in the wealthy, industrialized nations (e.g Japan, Germany, Great Britain and the United States). These countries have sophisticated accounting systems and highly qualified professional accountants. In contrast, education levels in most developing countries are low and businesses are small. As a result, accounting is primitive. From earlier discussion however, it may occur to you that if accounting responds to information needs, then accounting in developing countries may very well be at an appropriate level of sophistication under the circumstances. While many accountants hold this view, some feel that the lack of sophisticated accounting ability in less developed countries actually impedes their potential for economic progress.

SELF ASSESSMENT EXERCISE
How does size and complexities of business enterprises affect accounting development?

4.0 CONCLUSION

From the foregoing, you would appreciate the fact that accounting development differs from country to country. This is due to the fact that accounting development is very much a function of external finance, legal system, political and economic ties with other countries, and levels of inflation, size and complexity of business enterprises, sophistication of management, the financial community and general levels of education of the country in which the accounting system exists. The objectives of the accounting system are often linked from an historical perspective to goals and objectives of the perceived and users of the financial statements.

5.0 SUMMARY

In this unit, you would recall that we discussed those factors that influence accounting development. One of such factors is external finance, which simply shows the information need that would meet the demand of those that provide the finance. The legal system shows the standard behaviour expected by the government. Political and economic ties with other countries show the influence on accounting development in a country from other countries due to certain considerations such as proximity of both countries. Another factor is the levels of inflation. Accounting in many countries is based on the historical cost principle and the reasonableness of the historical cost principle varies inversely with the level of inflation. Finally, size and complexity of business enterprises, sophistication of management and the financial community and general levels of education as factors that influence accounting development are all factors that define the limits of a country's accounting sophistication.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss external finance as a factor influencing accounting development.

2. Discuss legal system as a factor influencing accounting development.

3. Discuss political and economic ties with other countries as a factor influencing accounting development.
4. Discuss the levels of inflation as a factor influencing accounting development.

5. Discuss the factors that show the limits of a country's accounting sophistication.

7.0 REFERENCES/FURTHER READING

Bailey, D. (1995)," Accounting in Transition in the Transitional Economy". European Accounting Review 4, no. 4 pp 595 – 623.

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MODULE 1: GLOBALIZATION OF ACCOUNTING

UNIT 3: DIVERSITY OF FINANCIAL ACCOUNTING PRACTICES

CONTENT

1.0 INTRODUCTION

In unit 2, we discussed those factors that influence accounting development. However, in this unit, we shall proceed further in discussing the diversity in financial accounting practices.

As business become more international, there is a more pressing need for financial information to be prepared by businesses on a comparable basis. Unfortunately, international financial data are frequently not comparable. The rules of financial accounting often differ from one country to another.

It is important you note that major environmental variables that shape accounting development in a country as discussed in unit 2, is one of the reasons why accounting and financial reporting are not the same everywhere. In addition to that, it is in the light of this unit to give further reasons such as accounting groups which a country belong by adherences to a particular financial accounting models and some existing practices differences. The unit further dealt with the consequences of international accounting diversity.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. List and describe the three accounting models.

2. Discuss some existing financial accounting practice differences using goodwill, income smoothing and asset valuation.

3. Explain the opinion of corporate management, investors, stock markets and regulators and accounting professionals and standard setters regarding international accounting diversity.

3.0 Main Content

3.1 ACCOUNTING GROUPS

Nations can be grouped according to accounting similarities. However, it is important you note that no two countries have identical financial accounting practices. Each country is a unique mixture of environmental variables that together have influenced the pattern of accounting development in that country. Therefore, at a broad level of generation, three major accounting models can be identified. And they are as follows:

British-American Model

The term British-American has been used to describe the accounting approach found in the United Kingdom and the United States. The Dutch approach is quite similar; and to be more precise, one should really call this model British-North American-Dutch. The United Kingdom, the United States and the Netherlands are the trend-setting countries for this accounting group.

Their accounting is oriented towards the decision needs of investors and creditors, and they have large, developed common stock and bond markets where companies raise large amounts of capital. Education levels are very high, and users of financial accounting information tend to be quite sophisticated. These countries also possess many large multinational corporations. Besides the three countries mentioned above, are other countries such as Australia, India, Nigeria, South Africa, Tanzania, Malaysia, and Ghana and so on.

Continental Model

Countries in this accounting group include most of continental Europe and Japan. Businesses here have very close ties to their banks, which supply most capital needs. Financial accounting is legalistic in its orientation, and practices tend to be highly conservative. Accounting is not primarily oriented toward the decision making needs of the capital providers. Instead, it is usually designed to satisfy such government- imposed requirements as computing income taxes or demonstrating compliance with the national government’s macroeconomic plan. French speaking African countries follow the continental financial accounting model.

South American Model

The third model includes most countries in South American, with the exception of Brazil, which speaks Portuguese; these nations share a common language-Spanish. They also share a common heritage. What distinguishes the South American model from the British-American and Continental models are the persistent use of accounting adjustments for inflation. These countries have a great deal of experience coping with inflation, and their accounting reflects this. Generally, accounting is oriented towards the needs of government planners, and uniform practices are imposed on business entities. Tax-basis accounting is often used as well for financial reporting purposes.

SELF ASSESSMENT EXERCISE
Explain the British-American Model

3.2 SOME EXISTING PRACTICE DIFFERENCES

Let us discuss some existing practice differences using goodwill, income smoothing and asset valuation.

Goodwill

When a company buys another company, a business division, or some other business enterprises, it typically anticipates greater benefits than the fair market values of the net assets acquired. Perhaps such benefit could be an added team of executives which will bring about major synergy, or maybe certain patents or processes lend themselves to higher profit potential. Whatever the anticipated benefit, to the extent that purchase price exceeds total fair market value, something called goodwill is created.

Considerable diversity exists among countries on whether purchased goodwill should be carried on balance sheets, and if so, whether it should be amortized. Three main methods have emerged:

1. Capitalization without amortization- under this method, goodwill is recognized as an asset with an indefinite life. Thus, it remains on the balance sheet.
2. Capitalization with amortization- here, goodwill is recognised as an asset with a finite life. It is written off over time either to income (which reduces annual income) or to equity (which does not reduce annual income). The shorter the life, the greater the write-off.
3. Immediate write-off- instead of capitalizing, goodwill is written off at acquisition. Typically, it is written off to equity, which leaves annual income unaffected.

The goodwill accounting diversity is aggravated by a taxation effect. For instance, goodwill amortization is not tax deductible in the United Kingdom or the Netherland, but it is deductible in Canada, Japan, Germany (post-1986), and the United States (post-1993). The diversity involved affects business practices and therefore global competitiveness. If a company can permanently shield its income statements from goodwill amortization, it will report comparatively higher net earnings and thereby may gain a competitive advantage.

Income Smoothing

Managers of most companies like to present a smooth income pattern from one year to another, preferably a pattern with steady, predictable annual increases. A volatile income pattern normally suggest a company with higher risk of operations, which often leads to lower investor confidence and higher costs of obtaining financing. Smooth income normally means the opposite: less risk, greater investor confidence and lower financing costs.

The opportunities allowed by Generally Accepted Accounting Practices (GAAP) to smooth income vary greatly around the world. The GAAP of some countries for example, the United States, allow little flexibility for income smoothing. By contrast the practice is a notable feature of German and Swiss accounting. Here, GAAP have built in flexibility that managers routinely take advantage of. The GAAP of still other countries actually encourage income smoothing by companies as a way to stimulate a long-term view of companies' operations and to encourage overall confidence in the nation's economy.

The focus of this section however, is on the quite legitimate use of accounting principles to shift income from one year to the next. Particularly, let us consider the use of provisions and reserves as income smoothing devices. One way is to judiciously choose the amounts of provisions that achieve the desired net income for the year. Or one might even omit a provision if "necessary" in some year. However, reserves can also be "drawn down" in particularly bad years to increase income. In other words, a reserve is decreased and a negative provision recorded in order to increase income.

Some observers argue that the use of provisions and reserves deceives financial statement readers while this is arguably possible, it is important to bear in mind that, as discussed here, the practice is a legitimate application of a nation's GAAP, allowed or even encouraged in certain countries. Whether things are kept secret will also depend on what the country's GAAP requires companies to reveal. In addition, income smoothing opportunities are often tied to a nation's income tax laws. In general, income smoothing is more often practiced in code law countries where financial accounting and taxation are strongly linked.

Asset Valuation

Financial accounting in most countries is based in part on the historical cost principle. This principle is based on the assumption that the currency unit used to report financial results is reasonably stable- that is, there is little or no inflation. Consequently, strict historical cost accounting does not recognise the effects of inflation or other price changes. However, severe inflation is a potential force that can strain the historical cost principle. The reasonableness of the historical cost principle varies inversely with the severity of price changes.

There are two basic approaches to accounting for changing prices. They are general purchasing power (GPP) and current cost accounting (CCA). The GPP uniformly changes the values of assets and liabilities to reflect the general change in the currency unit's purchasing power. While transactions are initially record at their historical costs, they are later notched up or down by changes in the currency' general purchasing power. Consequently, the items on the balance sheet and income statement are reported in units of the same purchasing power.

GPP is most often associated with Latin America. These countries have contended with high inflation rates for a long time and as a result, accounting for changing prices is an issue too serious for their accountants to ignore. Bolivia, Chile and Mexico require companies to comprehensively restate their financials on the basis of changes in general purchasing power. Several others require that fixed assets be revalue at certain intervals for changes in the price level.

The CCA changes the historical costs of assets to their current values and recognizes corresponding expenses at the current cost of obtaining the services represented by those expenses. Many accountants first think of the Netherlands when CCA is mentioned. That is because Dutch accountants have devoted more attention to it over longer period of time than accountants in other countries. Accounting in the Netherlands is heavenly influenced by business economics (or microeconomics). A fundamental notion in business economics is that the input values of a company' goods and services must be less than their selling prices in order to make profit, hence, ensure survival. Use of current values is thought to best accomplish this, while at the same time preserving the amounts permanently invested in the business firm.

Some countries adapt a piecemeal approach. Many countries allow the selective use of CCA. This means that only some assets are revalue to current market values and that such revaluations are done at management's discretion.

SELF ASSESSMENT EXERCISE
What are the various perspectives of treating purchased goodwill?

3.3 CONSEQUENCES OF INTERNATIONAL ACCOUNTING DIVERSITY

We could see that there are evidences available to conclude resolutely that GAAP differ from country to country. Whether this is good or bad depends on the points of view of a variety of interest groups such as corporate management, investors, stock markets and regulators, and accounting professionals and standard setters. Let us discuss their various opinions about accounting diversity.

Corporate Management

Managers of companies with strictly domestic operations care little about accounting diversity. As long as national GAAP are relatively clear, useful and broadly applied, most medium sized and small companies feel well served by the accounting rules they have to contend with. The multinational companies (MNCs) see it differently. They face global competition every day and sense that accounting diversity affects competitiveness. The MNCs like "level playing fields" for their global operations. Working with many different national GAAP requirements is an expensive proposition. Companies must be careful to communicate effectively with their foreign shareholders.

Investors

Portfolio investors and their agents, financial analysts, probably dislike international accounting diversity the most. Underwriters consistently report that worldwide accounting diversity causes some underwriting (i.e. pricing of new securities issues) difficulties. If investors, analysts and underwriters indeed experience difficulties with GAAP diversity, financial markets are not as efficient as they could be and therefore returns to investors are less than they ought to be. This is a powerful indictment on GAAP diversity.

Stock Markets and Regulators

Stock markets and regulators have twin goals of investor protection and market quality. To protect investors, most stock markets (along with professional or governmental regulatory agencies) require listed companies to disclose sufficient information so that investors can assess their past performance and future prospect. Market quality is achieved by fair and efficient trading and by the availability of investment opportunities for market participants. Stock markets and regulators interpret these goals differently around the world. For example, accounting and disclosure requirements for listing shares vary extensively. Research shows that MNCs consider these requirements to be an important cost when they choose where to list their common stock shares. Indeed, MNCs are less likely to choose stock exchanges that require them to make extensive new disclosures over and above those that they are already making at home.

The United States has the most extensive accounting and disclosure requirements in the world. The US Securities and Exchange Commission (SEC) is the regulatory agency responsible for these requirements. The SEC believes that investors are better protected when there is a "level playing field", that is, when comparable accounting information is provided by U.S. and non-U.S. companies alike. Nevertheless, non-U.S. companies allege that they avoid listing in the United States because they find US requirement too onerous. If that is true, then U.S. citizens are deprived easy access to buying shares in these companies, and the U.S. capital market may become less competitive globally.

Accounting Professionals and Standard Setters

Some have suggested that accounting professionals like diversity because it generates fees for them all the way from assisting in setting up new business units for their clients in different GAAP territories to restating financial reports from one set of GAAP to another. GAAP diversity also makes cross-border auditing more costly and therefore raises auditing fees. Even though not demonstrated by realisable research, it stands to reason that at least some accosting professionals gain from the GAAP diversity factor.

Accounting standard setters, as guardians of public interest, would like to have full authority over all GAAP and financial reporting of companies whose securities are publicly held or whose size is so large that the public interest is affected. But regulations are primarily enforced through national laws and national legal systems. Therefore, a national focus is inevitable for accounting regulation- at least for the time being. Moreover, national regulators want discretion over national GAAP. International or any other GAAP are beyond their reach of influence and hence unacceptable.

4.0 CONCLUSION

Worldwide diversity in financial accounting and reporting exists. Some reasons have been put forward to explain this diversity. In some cases, the diversity among national GAAP is significant; in others it is not. There are some winners and some losers as a result of the diversity condition. When diversity reaches the point of misinformation, it becomes dysfunctional. National environmental factors together with national laws and national accounting standard setting systems will make some degree of GAAP diversity inevitable. However, in domestic terms, national GAAP have reduced practice diversity. A similar degree of diversity reduction may be desirable on the international level. Harmonization of accounting practices is aimed at such reduction.

5.0 SUMMARY

In this unit, we discussed the diversity in financial accounting practices. This was discussed in three sub-units which are accounting groups, some existing practice differences and consequences of international accounting diversity. Accounting groups and some existing practice differences are further reasons for diversity in financial accounting practices while consequences of international accounting diversity explains the opinion of various stakeholders about the presence of accounting diversity.

6.0 TUTOR MARKED ASSIGNMENT

1. List and describe the three accounting models.

2. Discuss some existing practice differences using goodwill.

3. Explain the position of corporate management and investors on the acceptability of international accounting diversity.

7.0 REFERENCES/FURTHER READING

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MODULE 1: GLOBALIZATION OF ACCOUNTING

UNIT 4: GLOBAL ASSESSMENT OF DISCLOSURE PRACTICES

CONTENT

1.0 INTRODUCTION

The term disclosure in its broadest sense encompasses the release of any piece of information about a particular company. It includes everything contained in the company's annual report, press releases, newspapers and magazine stories and so on. However, this unit is more narrowly focused. It is about disclosure contained in annual report information besides that in the main financial statements- the balance sheet, income statement and statement of cash flows.

Measurement issues are concerned with how financial statements should be prepared and how assets and liabilities are to be valued. On the other hand, disclosure issues relate to the information in an annual report that supplements the financial statements.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Distinguish between financial and nonfinancial disclosure.
2. Explain the bases used for ensuring disclosure.
3. Discuss the following:

    d. Segment disclosure

    e. Financial forecast disclosures

f. Information about shares and shareholders disclosure

3.0 MAIN CONTENT

3.1 FINANCIAL AND NONFINANCIAL DISCLOSURE

Disclosure in financial reports is often classified as either financial or nonfinancial. Financial disclosures consist of those items of information quantifiable in monetary amounts (naira, for Nigeria companies). For example, companies often report one figure for stock on the balance sheet but show in the notes to the account, how much of that is finished goods, how much is raw materials and so on. A company may show one amount for property in the balance sheet and reveal in a note to the account, how much is located in Nigeria or the home country and how much is located outside the home country and so on.

When a company signs a long-term contract obligating it to rent property for a number of years, that obligation does not fit the definition of a liability and therefore will not appear on the balance sheet. However, because cash has been committed for future years, much like the commitments that are considered liabilities, companies generally show lease obligations in the notes to the accounts. Similarly, if a company is a defendant in lawsuit, it wants shareholders to know the amounts of potential damages it may be liable for. The case may not have progressed for enough in the courts for the defendant to know whether it will actually have to pay damages. And so, in the meantime, it reveals in the notes to the accounts the general circumstances surrounding the lawsuit. These are all types of financial disclosure seen in financial statements.

Nonfinancial disclosure is either

1. Narrative descriptions, facts or opinions that do not readily lend themselves to quantification in monetary terms e.g. a company's mission statement.

2. Items of information quantified in something other than money e.g data about the number of employees located in each country. Labour cost per country is a financial disclosure but number of employees is nonfinancial disclosure.

Nonfinancial disclosures may be just another way to express things that are already expressed monetarily in the financial statements. Most of the information that accountants provide is financial-financial statements and financial disclosures. However, not everything can be expressed monetarily, and nonfinancial disclosure can be very important.

SELF ASSESSMENT EXERCISE
What do you understand by financial and non-financial disclosure?

3.2 BASES OF DISTINGUISHING DISCLOSURE

Disclosures can also be distinguished based on whether they are required or suggested, or whether they are voluntary. While most countries require certain disclosures to be made by companies operating within their borders, the amount of disclosure required varies by country. Often the GAAP of a particular country will also suggest items to be disclosed in companies' annual reports. Many companies, though, disclose information that is neither required nor suggested; that is, some disclosures are completely voluntary. Disclosure that are required or suggested in one country may be voluntary in another, vice versa.

The fact that companies sometimes disclose more than they have to, suggests that they perceive some advantages in doing so. In particular, it appears that the worldwide competition for investment funds is the most important force propelling increased levels of disclosure by multinational corporations (MNCs). MNCs significantly increase disclosure whenever they seek major amounts of new funds.

Disclosure can also enlarge the scope of interest in a company by expanding the annual report's audience. After all, the annual report is the major medium of getting people interested in what the company is doing. Disclosure enables the firm to maintain the primary orientation of its financial statements and provide information of interest to other parties as well.

Disclosure can overcome differences in generally accepted accounting principles. Until a worldwide harmonization of accounting practices is achieved, disclosure can be effective mechanism for overcoming these problems.

Deciding what and what not to disclose is not always an easy decision for corporate management to make. If they decide not to disclose an item of information, in a very real sense, they have chosen to keep something secret from financial statements users. Many things, of course, are simply irrelevant to users of financial statements. But for many items of information, managements must use judgment to decide on their usefulness to financial statement readers. If too much information is disclosed, a reader can easily get lost. So, management need a way to pare down the amount of information revealed in financial statements.

Disclosure is a substantive issue, since information revealed can potentially affect people's decisions and actions. Unrevealed information does not have that potential. When GAAP requires a disclosure, this is tantamount to saying that the information is potentially significantly enough to affect decision and therefore, ought to be revealed. A suggested disclosure or a voluntary disclosure should be made whenever knowledge of that information has the potential to influence the decisions of financial statement users.

SELF ASSESSMENT EXERCISE
Disclosure is a substantive issue. Explain.

3.3 DISCLOSURE WITH INTERNATIONAL PERSPECTIVE

What, how much and how a company discloses supplemental information varies depending on

1. The requirements of generally accepted accounting principles.
2. The needs of users.
3. The influence of users.
4. The philosophy of management.

This sub-unit would aimed at discussing certain examples of disclosure from an international perspective which are as follows

1. Segment disclosures

   Consolidated financial statements combine the separate financial statements of a parent company and its subsidiaries so that a single set of financial statements is issued for the entire economic entity. The argument is that for a multinational corporation operating in a number of different product lines, consolidated financial statements may in fact hide some important information. If a company's continued profitability depends heavily on a certain region of the world or on a particular product, knowledge of that may be useful to shareholders, creditors, employees and other financial statement users. Thus, in addition to consolidated financial statements, perhaps companies should be more detail about where and how total profits are derived.

2. Financial Forecast Disclosures

   Given that a primary concern of investors is assessing a company's future profitability and cash flows, it is reasonable to ask whether companies provide their own internal forecasts of such financial information. Financial forecasts would seem to be relevant information for investors. In practice, few MNCs provide them. One reason is that forecasts can be unreliable because they incorporate subjective estimates of uncertain future events. In addition, there can be legal repercussions for managements if the forecasts are not met. In litigious countries such as the United States, the potential for lawsuits is a major deterrent to providing financial forecasts.

3. Information about Shares and Shareholders

   A number of continental European companies disclose rather extensive information about their shares and shareholders. The value of such information is aimed at current and prospective shareholders. Past trend data can be useful in predicting future patterns and it is also useful when making comparisons with the trends of other companies. Shares are more marketable when they are traded on several exchanges and when the volume of trading is high. Widely scattered ownership tends to provide ready sales opportunities when present shareholders wish to dispose of some or all of their share holdings. Ownership concentration also indicates the locus of corporate control. On the other hand, dispersed ownership normally means that the company is controlled by shareholders and their agents, the company's management team. On the other hand, a concentrated ownership suggests that power is exerted by a more narrowly defined group. Management may be constrained if a large block of shares is owned by relatively few individuals or groups, and other shareholders may have relatively less influence in such situations. The identities of the largest shareholders might also be of interest to current and potential shareholders for the same reason. There are no standards that require companies to provide information about shares and shareholders, although, the practice seems to be growing.

SELF ASSESSMENT EXERCISE
Explain financial forecast disclosures.

4.0 CONCLUSION

Back in the 1960s and 1970s a disclosure explosion took place in most industrially developed countries, mandated by new national laws. Companies began revealing information about them that they had never revealed before. A major motivation for such laws seemed to be a low level of investor confidence. Beyond that, companies began to realize that secrecy is self-defeating. Failure to make reasonable disclosures in response to user needs can severely limit the pool of funds available to a corporation. Potential provider of capital, when kept in the dark will simply put their money elsewhere. Studies by accountants have shown that firms significantly increase disclosure levels when they seek new sources of investment funds, that differences in disclosure levels among nations are rapidly narrowing and that increased disclosure can lead to lower costs of capital for business enterprises.

5.0 SUMMARY

In this unit, you would recall that the unit is focused on global assessment of disclosure practices. Basically, the topic was discussed in three sub-units which are financial and nonfinancial disclosure, bases of distinguishing disclosure and disclosure with international perspective.

From the discussion, we explained that disclosure issues relate to the information in an annual report that supplements the financial statements. We also discussed disclosure in financial reports are often classified as either financial or nonfinancial. Further distinguishing of disclosure was discussed based on whether they are voluntary. Furthermore, disclosure was discussed considering an international perspective of disclosure using three examples such as segment disclosures, financial forecast disclosures and information forecast disclosures and information about shares and shareholders.

6.0 TUTOR MARKED ASSIGNMENT

1. Distinguish between financial and nonfinancial disclosure.

2. Explain the bases used for ensuring disclosure.

3. Discuss the following examples of disclosure

   a. Segment disclosure.

   b. Financial forecast disclosures.

   c. Information about shares and shareholders disclosure.

7.0 REFERENCES/FURTHER READING

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 1: PROMOTION OF INTERNATIONAL ACCOUNTING HARMONIZATION

CONTENT

1.0 INTRODUCTION

National environmental factors together with national laws and national accounting standard setting systems will make some degree of GAAP diversity inevitable. But when diversity reaches the point of misinformation, it becomes dysfunctional. Therefore, some degree of diversity reduction should be desirable at the international level.

In the previous unit, we discussed diversity in financial accounting practices. In this unit, we shall step further by discussing promotion of international accounting harmonization. Harmonizing accounting standards internationally will improve the comparability of accounting information around the world and thereby eliminate one source of misunderstanding in transnational financial reporting. It is in the light of this unit to discuss the relationship of accounting and auditing standards and the benefits and barriers of accounting harmonization.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain the purposes of accounting and auditing standards and how they are related.
2. List and explain the benefits of accounting harmonization.
3. List and explain the barriers to accounting harmonization

3.0 MAIN CONTENT

3.1 ACCOUNTING AND AUDITING STANDARDS

In this sub-unit, we shall discuss the relationship between accounting and auditing standards. Accounting standards are the rules for preparing financial statements: that is the "generally accepted accounting principles" (GAAP) that specify the type of information that financial statements ought to contain and how that information ought to be prepared. Accounting standards define what is acceptable and unacceptable financial accounting practices.

Auditing standards are the rules governing how an audit is performed. An audit of financial statements is the technical process by which an independent person (the auditor) gathers evidence to form an opinion about how well a set of financial statements conforms to GAAP. In most countries, a particular group of accountants is legally empowered to conduct financial statements audits. In the United States, for example, it is the certified public accountant (CPA). In the United Kingdom, it is the chartered accountants. In the Netherlands, it is the register accountant. In Germany, it is the wirtschafts prufer. In Nigeria, it is mainly the chartered accountants. Financial statements conforming to GAAP are said to be 'reliable' and reliable information is an important ingredient in good decision making.

Accounting standards and auditing standards are interrelated. Accounting standards presumably define what useful financial information is. Auditing standards guide an auditor in determining whether it is also reliable. Useful and reliable financial information puts investors, creditors and others in a position to make better decisions. Accounting has been called the language of business. That analogy is accurate, since accounting is a form of communication. As with all types of communication, though, misunderstanding can arise unless meanings are reasonably clear.

To minimize the possibility of misunderstanding financial communications, approximately 50 countries have created their own national financial accounting standard setting mechanisms. This has harmonized financial accounting diversity within countries. Unfortunately, international diversity continues to exist. This diversity results in a general lack of comparability in financial reports from one country to the next. As a result, there is a risk of misunderstanding when financial statements are communicated transnational.

The problem of different auditing standard is more subtle. Fundamentally, an audit assures users that they can trust the information communicated by the financial statements. However, if auditors around the world are not comparably trained or if they do not observe comparable standards, then their work varies in quality. Consequently, the inherent reliability of financial statements also varies.

SELF ASSESSMENT EXERCISE
What is an auditing standard?

3.2 BENEFITS OF ACCOUNTING HARMONIZATION

Having explored diversity in financial accounting practices, we can better appreciate the benefits that can be obtained from harmonization. The following can be obtained as benefit from harmonization.

1. Uniform financial reporting- it is the goal of harmonization to give the same financial reporting treatment for like transactions and event by different enterprises in different countries.

2. Coverage for diversities- harmonization accommodates differences in accounting treatment for different transactions and events.

3. Platform for comparison- accounting harmonization provides a level playing field of comparable information on cross-country company comparison to enable investors or creditors make accurate business decision.

4. Standard for regulators- accounting harmonization obligates regulators to ensure that they fulfil their responsibility of providing comparable information to their domestic investors.

5. International transparency- accounting harmonization encourages capital market to be open, fair and transparent in order to attract international investors and creditors.

SELF ASSESSMENT EXERCISE
Outline the benefits of harmonization.

3.3 BARRIERS TO ACCOUNTING HARMONIZATION

There are many barriers in the global environment that make harmonization difficult to achieve. Let us discuss some of such barriers in this sub-unit.

1. Nationalism and pride- each nation's nationalism and pride can serve as barrier to accounting harmonization. It will be difficult to get a country's standard setters to accept alternative principles when they clearly believe that the standards they have developed provide the best information from their national perspective. Countries' standard setters have different objectives and users. For instance, the primary objective of financial reporting in the United States is to meet the need of shareholders, while in Germany the creditors' perspective is the main concern of the financial reporting process. Finally, a country's legal tradition also influences its perspective. The United Kingdom has a common-law tradition, so it naturally prefers more flexibility and less codification in its standards. Germany has a Roman law tradition, which emphasizes stricter interpretation of the rules.

2. Costs- there are a number of costs in achieving harmonization. The level of costs to be incurred depends upon the manner in which harmonization is achieved. If harmonization is achieved by developing a loose, flexible framework into which a country's accounting standards fit, the costs would be far less than if a specific, rigid set of accounting standards were imposed uniformly on all companies in all countries.

3. Difficulty- harmonization is achieved through reconciliation to an agreed benchmark such as International Accounting Standards (IAS) or U.S GAAP. With the exception of IAS, at the event of resolving accounting issues, it is required to determine the country's accounting profession or standard setters that have the standing to resolve the accounting issues. This is obviously a difficult task to manage given the rate of change in various countries' GAAP.

SELF ASSESSMENT EXERCISE

What are the barriers to accounting harmonization?

4.0 CONCLUSION

The goal of international harmonization of accounting and auditing has been widely accepted. The reason is the globalization of capital markets and the large number of companies listing their shares on "foreign" stock exchanges. Diverse accounting practices used to represent the same reality make little sense as investors everywhere seek comparable financial reporting from companies, no matter where they come from. The debate has moved on from whether harmonization is desirable or practical to how best to achieve it.

5.0 SUMMARY

In this unit, you would recall that we discussed the relationship between accounting and auditing standards, the benefits of accounting harmonization and the barriers of accounting harmonization. Accounting standards are the rules for preparing financial statements. Auditing standards are the rules governing how an audit is performed. The benefits of accounting harmonization include uniform financial reporting, coverage for diversities, platform for comparison, standard for regulators and international transparency. The barriers to accounting harmonization include nationalism and pride, costs and difficulty.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the relationship between accounting standards and auditing standards.

2. List and explain four benefits of accounting harmonization.

3. List and explain three barriers to accounting harmonization.

7.0 REFERENCES/FURTHER READING

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 2: INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE (IASC)

CONTENT

1.0 INTRODUCTION

The use of financial statements as a medium of communication by companies has been steadily increasing. It is now widely recognised that they are a prime source of information for investors, employee groups, government agencies and many other bodies.

Investors in international markets need to be sure that the information on which they base their assessment is compiled using accounting principles recognised in their own country and comparable with others regardless of the country of origin. Interest groups such as employees, government agencies and regulatory bodies will only find financial statements acceptable if they are based on standards which are relevant, balanced and internationally comparable.

International Accounting Standards are the rules for preparing financial statements. That is, the “generally accepted accounting principles” that specify the type of information that financial statements ought to contain and how that information ought to be prepared for worldwide acceptance.

The International Accounting Standards Committee which founded in 1973 has till date issued 39 IAS. Many of the professional accountancy bodies that are members of IASC have published the texts of international accounting standards in their own countries. Such publications usually include national prefaces or other material that explains the application of international accounting standards in the country concerned. Copies of these publications are available from the appropriate accountancy body. In addition, various professional accountancy bodies have prepared and published translations of IAS.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. State the objectives of IASC.
2. State the obligations member countries of IASC are expected to do to support the objectives of IASC.
3. List and discuss the operating structure of IASC.
4. Describe the operating procedures of IASC for setting up accounting standards.

3.0 MAIN CONTENT

3.1 PURPOSE AND OBJECTIVES OF INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

The International Accounting Standards Committee came into existence on 29th June, 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United States, United Kingdom and Ireland. A revised agreement and constitution were signed in November 1982. The business of IASC is conducted by a Board comprising representatives of up to thirteen countries and up to four organizations having an interest in financial reporting.

The objectives of IASC as set out in its constitution are:

a. To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance and
b. To work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

The relationship between IASC and the International Federation of Accountants (IFAC) is confirmed by the mutual commitments into which they have entered. The membership of IASC (which is the same as IFAC) acknowledges in the revised agreement that IASC has full and complete autonomy in the setting and issue of International Accounting Standards (IAS). The members agree to support the objectives of IASC by undertaking the following obligations to support the work of IASC by publishing in their respective countries every international accounting standard approved for issue by the Board of IASC and by using their best endeavours:

1. To ensure that published financial statements comply with international accounting standards in all material respects and disclose the fact of such compliance.
2. To persuade governments and standards setting bodies that published financial statements should comply with international accounting standards in all material respects.

3. To persuade authorities controlling securities markets and the industrial and business community that published financial statements should comply with international accounting standards in all material respects and disclose the fact of such compliance.

4. To ensure that the auditors satisfy themselves that the financial statements comply with international accounting standards in all material respects.

5. To foster acceptance and observance of international accounting standards internationally.

SELF ASSESSMENT EXERCISE
What are the objectives of IASC as set out in the constitution?

3.2 OPERATING STRUCTURE OF IASC

IASC recognises the need to be fully representative and has accordingly made a number of important changes to its structure.

1. The IASC Board

   The business of IASC is conducted by the Board assisted by a full-time secretariat. The professional accountancy bodies in thirteen countries are now represented on the Board. It is IASC policy that appointments to the Board will preferably include a minimum of three developing countries. The constitution of IASC provides for up to four international organizations which have an interest in financial reporting to be represented on the Board.

2. The Consultative Group

   International organizations representing many of the principal preparers and users of financial statements participate in the consultative group. The consultative group meets regularly with the IASC Board, enabling group members to discuss matters of principle and policy arising from IASC's work, and the practical and conceptual issues which affect the acceptability of international accounting standards.

3. Steering Committee

   Steering committees are formed to consider the issue relating to a particular accounting topic. They comprise four members of which at least one is a board member and whenever possible, one is a representative of a developing country. Member bodies not on the IASC Board are invited to participate in steering committees, the costs of which are borne by IASC.

4. Liaison with national standard setting bodies

   To be fully aware of the difficulties facing individual national standard-setting bodies, IASC believes close liaison is required. The primary points of contact are through the Board representative or the professional accountancy body in the member country. In addition, the national standard setting bodies are visited by IASC delegations to discuss the various problems of implementation and harmonization of standards.

SELF ASSESSMENT EXERCISE
State and explain the structure of IASC.

3.3 OPERATING PROCEDURES OF IASC

The process of exposure and comment is essential to the success of IASC. As well as providing preparers, auditors and users of financial statements with the opportunity to express their view on the accounting standards to be adopted. It is also essential to the maintenance of the quality of international accounting standards.

The procedure of exposure and comment is as follows:

a. The IASC Board selects a topic that is felt to need an international accounting standard and assigns it to a steering committee. All IASC member bodies are invited to submit material for consideration.

b. The steering committee, assisted by the IASC secretariat, considers the issues involved and presents a point outline on the subject to the Board.

c. The steering committee receives the comments of the Board and prepares a preliminary draft of the proposed standard or a statement of principles.

d. Following review by the Board, the draft or statement is circulated to all member bodies for their comments.

e. The steering committee prepares a revised draft, which after approval by at least two-thirds of the Board, is published as an Exposure draft. Comments are invited from all interested parties.

f. At each stage in the consideration drafts, member bodies refer for guidance to the appropriate accounting research committees in their own organizations.

g. At the end of the exposure period (usually six months) comments are submitted to IASC and are considered by the steering committee responsible for the project.

h. The steering committee then submits a revised draft to the Board for approval as an international accounting standard.

i. The issue of a standard requires approval by at least three-quarters of the Board, after which the approved text of the standard is sent to all member bodies for translation and publication.

The above process takes approximately three years. During the process, the IASC Board may decide that the needs of the subject under consideration would be better served by issuing a discussion paper for comments. The intention of such a paper may be to promote discussion of a topic that is not yet ready for an international accounting standard, or to ensure that adequate time is allowed for a full discussion of the various points of view on a complex accounting subject. The monitoring of views and needs on a subject does not stop when an international accounting standard is issued.

IASC constantly reviews the effectiveness of its standards both in terms of practical compliance and of the need for updating. From time to time, IASC revises document to take into account the current position.

SELF ASSESSMENT EXERCISE
Outline the procedure of exposure and comment to the success of IASC.

4.0 CONCLUSION

The IASC or the accountancy profession does not have the power to enforce international agreement or to require compliance with international accounting standards. The success of IASC's effort is dependent upon recognition and support for its work from many different interested groups acting within the limits of their own jurisdiction. Recognition of IASC's work comes from groups such as the international bodies representing financial institutions, financial executives, trade unions, employers, stock exchanges, lawyers, securities commissions and financial analysts involved in the Board and consultative group. Others include the United Nations (UN), the Organization for Economic Cooperation and Development (OECD) and the International Federation of Accountants.

5.0 SUMMARY

In this unit, you would recall that we discussed International Accounting Standards Committee. We discussed the IASC from three perspectives. First, we looked at the purpose and objectives of IASC which discussed the historical background and objectives of IASC considering the relationship with IFAC. Second, the operating structure of IASC which shows; the IASC Board, the consultative group, the steering committee and liaison with national standard-setting bodies. And finally, the operating procedure of IASC which shows how the IAS is developed and approved for use.

6.0 TUTOR MARKED ASSIGNMENT

1. State the objectives of IASC.

2. State the obligations member countries of IASC are expected to do to support the objectives of IASC.

3. List and discuss the operating structure of IASC for setting up standard.

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 3: INTERNATIONAL FINANCIAL REPORTING STANDARDS

CONTENT

1.0 INTRODUCTION

A business enterprise that receives capital from investors and creditors or one that is seeking new capital has an obligation to keep its capital providers informed about the company's performance, condition and prospects. In a word, the business is accountable to its investors and creditors. It is also accountable to others who provide resources or an environment in which to operate, such as employees, governments, and the community at large. Providing this information is the role of financial accounting and reporting.

Historically, the rules for what financial information should be provided and in what format have evolved country by country. By the last quarter of the twentieth century, a mechanism for developing and adopting accounting standards had been established in most countries.

In our previous unit, we discussed International Standards Committee (IASC). That was the state at a point in time. It is in the light of this unit to take you further with consideration for recent happenings in accounting standards and reporting.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Describe how the approval for the IASC restructuring was obtained.

2. Explain what the key responsibilities of IASB are.

3. State the specific objectives of IASB
4. Explain the IASB due process.
5. Discuss the qualification of IASB members.
6. Discuss the Standard Advisory Council.
7. Discuss the International Financial Reporting Interpretations Committee
8. State the benefits of global accounting standards.
9. State the justification for having international standard setters.
10. State the recent trends in International Financial Reporting Standards

3.0 MAIN CONTENT

3.1 RESTRUCTURING OF IASC INTO IASB

The committee that was entrusted with oversight of the IASC in 1998 undertook a comprehensive review of the IASC's structure and operations. That review was completed in 2000. The principal recommendations of the structure review were that:

1. The large, part-time IASC should be replaced by a smaller and essentially full-time International Accounting Standards Board (IASB or the 'Board').
2. The new IASB should operate under a broad based IASC Foundation (IASCF) whose trustees represented all regions of the world and all groups interested in financial accounting.
3. The new IASB should have Standards Advisory Council (SAC) to provide counsel to the board.
4. The Standing Interpretations Committee (SIC) should continue in a slightly modified form under the name of International Financial Reporting Interpretations Committee (IFRIC).

APPROVAL OF THE PROPOSED RESTRUCTURING

In November 1999, the IASC Board itself approved the constitutional changes necessary for its own restructuring. In May 2000, the Council of the International Federation of Accountants (IFAC) unanimously approved the restructuring. The constitution of the old IASC was revised to reflect the new structure. A new IASC Foundation was incorporated (under the laws of the United State of Delaware), and its trustees were appointed. By early 2001, the members of the IASB and SAC were appointed and the new structure became operational. Later that year, the IASB moved into new quarters in London.

The IASB's budget of U.S. $15 million per year was nearly five times that of the old IASC. The board meets monthly except for August, usually for four days. Three or four times a year the board meets with the chairpersons of certain major national standard setters, with a goal of mutual information and identification of steps toward convergence of accounting standards. Seven of the members of the IASB have specific liaison responsibilities with these national standard setters. The liaison countries are Australia, Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States.

KEY RESPONSIBILITIES OF THE IASB

The IASB has 14 members, 12 of which serve full-time and two part-time. The board's principal responsibilities are to:

1. Develop and issue international financial reporting standards and exposure drafts.

2. Approve interpretations developed by the IFRIC.

It is important you note that the new name for standards issued by the IASB is international financial reporting standards (IFRS's). In one of its earliest actions, the IASB voted to make clear that the international accounting standards (IASs) issued by the former IASC continue with full force and effect unless and until the IASB amends or replaces them. Therefore, the term IFRS encompasses IAS.

SPECIFIC OBJECTIVES OF THE IASB

As set out in IASB's constitution, the board's objectives are:

1. To develop, in public interest, a single set of high-quality, understandable, and enforceable global accounting standards that require high-quality, transparent, and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions.

2. To promote the use and rigorous application of those standards.

3. To bring about convergence of national accounting standards and IASs to high-quality solutions.

In accomplishing its objectives, the IASB has complete responsibility for all technical matters including the preparing and issuing of IFRSs and Exposure drafts (EDs), both of which must include any dissenting opinions, and final approval of interpretations by the IFRIC. The IASC Foundation trustees have no involvement in developing IFRSs. And IASB's use the term advisory groups rather than the old IASC term 'Steering Committees' reflects the purely advisory role of these groups- they no longer will "steer" technical projects in a direction supported by the "Steering Committee". Rather, they will serve as resources of expertise for the board.

IASB DUE PROCESS

Before issuing a final standard, the IASB must publish an ED for public comment. Normally, it will also publish a discussion document for public comment on major projects before it issues the ED.

The IASB has full discretion over its technical agenda. It may outsource detailed research or other work to national standard setters or other organizations. The board is responsible for establishing the operating procedures for reviewing comments on EDs and other documents. The IASB will normally form specialist advisory groups to give advice on major projects, though it is not required to do so. The IASB is required to consult the SAC on major projects, agenda decisions, and work priorities. The IASB will normally issue bases for conclusions with both final standards and EDs. Although there is no requirement to hold public hearings or to conduct field tests for every project, the board must, in each case, consider the need to do so. Standards and EDs are approved by Simple majority vote. Interpretations developed by IFRIC must also be approved by a simple majority vote of the IASB.

QUALIFICATION OF IASB MEMBERS

The key qualification for Board membership is technical expertise. The trustees also must ensure that the board is not dominated by any particular constituency or regional interest. To achieve a balance of perspectives and experience, at least five members must have backgrounds as practicing auditors, at least three of financial statement preparers, at least three as users of financial statements, and at least one as an academician. There is no required geographical mix.

STANDARDS ADVISORY COUNCIL

The international accounting standards advisory council has 49 members from 29 countries and five international organizations. The SAC provides a forum for organizations and individuals with an interest in international financial reporting to participate in the standard setting process. Members are appointed for a renewable term of three years and have diverse geographic and functional backgrounds.

The SAC normally convenes three times each year at meeting open to the public to:

1. Advise the board on priorities in the board's work.
2. Inform the board of the implications of proposed standards for users and preparers of financial statements.
3. Give other advice to the board or to the trustees.

INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

The IFRIC (until 2002 known as the Standing Interpretations Committee) has 12 members appointed by the IASC Foundation trustees for terms of three years. IFRIC members are not paid salary but their expenses are reimbursed. IFRIC meetings are open to public observation. Approval of draft or final interpretations requires that not more than three voting members vote against the draft or final interpretation. The IFRIC is chaired by a nonvoting chair who can be one of the members of the IASB, the Director of Technical Activities, or a member of the IASB's senior technical staff. The IFRIC's responsibilities are to:

1. Interpret the application of IFRSs and provide timely guidance on financial reporting issues not specifically addressed in IFRSs or IASs, in the context of the IASB's framework, and undertake other tasks at the request of the Board;
2. Public draft interpretations for public comment and consider comments made within a reasonable period before finalizing an interpretation.
3. Report to the board and obtain board approval for final interpretations.

By allowing the IFRIC to develop interpretations on financial reporting issues not specifically addressed in an IFRS or IAS, the new IASB constitution has broadened IFRIC's mandate beyond that of the former SIC.

SELF ASSESSMENT EXERCISE
What does the Standard Advisory Committee convene to do three times every year?

3.2 BENEFITS OF GLOBAL ACCOUNTING STANDARDS

Among the benefits often cited for a single set of global accounting standards are:

1. Easier access to foreign capital market.
2. Credibility of domestic capital markets to foreign capital providers and potential foreign merger partners.
3. Credibility to potential lenders of financial statements of companies from lesser-developed countries.
4. Lower cost of capital to companies.
5. Comparability of financial data across borders.
6. Greater transparency.
7. Greater understanding- a "common financial language".
8. Companies need to keep only one set of books.
9. Reduced national standard- setting costs.
10. Ease of regulation of securities markets- regulatory acceptability of financial information provided by market participants.
11. Still can have local implementation guidance for local circumstances.
12. Standards are less susceptible to political pressures than national standards.
13. Portability of knowledge and education across national boundaries.
14. Consistent with the concept of a single global professional credential.

JUSTIFICATION FOR HAVING INTERNATIONAL STANDARD SETTERS

1. There is a recognized and growing need for international standards.
2. No individual standard setter has a monopoly on the best solutions to accounting problems.
3. No national standard setter is in a position to set accounting standards that can gain acceptance around the world.
4. There are many areas of financial reporting in which a national standard setter finds it difficult to act alone.

SELF ASSESSMENT EXERCISE
What are the benefits of global accounting standard?

3.3 RECENT TRENDS IN INTERNATIONAL FINANCIAL REPORTING STANDARDS

The standards issued by the IASC in its last few years and the direction that the IASB has taken in its first few years allow the following observations about trends in international financial reporting standards:

1. Greater use of fair value in measuring transactions: financial instruments (trading investments), impairment recognition (write-down to fair values) and prohibition of pooling interests.

2. More fair values on the balance sheet: financial instruments (proposed by IASB in its IAS 39 revisions), investment property, commodity inventories, biological assets and agricultural produce, property acquired in exchange for similar property and venture capital funds.

3. More unrealized components of income: performance reporting becomes key.

4. No income smoothing, cost deferrals or general provisions: remove the corridor approach to pensions, balance sheet approach to deferred taxes, no accruals for future losses and rigorous hedge accounting rules.

5. Moving off-balance sheet items onto the balance sheet: special purpose entities, derivatives and stock compensation.

6. More disclosure, especially judgments, plans, and assumptions: judgment in applying accounting policies, risk management policies and sensitivity analysis.

7. Balance between relevance and reliability: shifting towards relevance.

SELF ASSESSMENT EXERCISE
Outline the observations about the trends in International Financial Reporting Standards.

4.0 CONCLUSION

In some cases, standard setting has been the responsibility of the public accounting profession, often with enforcement of the standards achieved by law or government regulation. In other cases, standard setting has been the responsibility of the government. In a few countries, private sector standard setter has been established that is independent of the public accounting profession. The Australian board is private but appointed by and under the oversight of a government agency.

5.0 SUMMARY

In this unit, you would recall we discussed international financial reporting standards. We discussed this topic from three sub-units which were restructuring of IASC into IASB, benefits of global accounting standards and recent trends in international financial reporting standards.

We discussed the approval of the proposed restructuring, the key responsibilities of the IASB, specific objectives of the IASB, IASB due process, qualifications of IASB members, standards advisory council and international financial reporting interpretations committee.

6.0 TUTOR MARKED ASSIGNMENT

1. Describe how the approval for the IASC restructuring was obtained.

2. What are the key responsibilities of IASB?

3. What are the specific objectives of the IASB?

4. Explain the IASB due process.

5. Discuss the qualification of IASB members.

6. Discuss the Standard Advisory Council.

7. Discuss the international financial reporting interpretations committee.

8. State the reasons for having international standard setters.

9. State five benefits of global accounting standards.

10. State the recent trends in international financial reporting standards.

7.0 REFERENCES/FURTHER READING

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MODULE 2: ACCOUNTING HARMONIZATION

UNIT 4: FINANCIAL REPORTING IN THE INTERNATIONAL ENVIRONMENT

CONTENT

1.0 INTRODUCTION

In our previous unit, we discussed the attempt made to harmonize accounting standard by establishing the International Accounting Standard Committee. Let us take it further by discussing financial reporting in the international environment.

Financial accounting practices in a country are determined by a number of environmental variables that interact in a complex way as discussed in unit 2 of this course material.

Companies prepare the financial statements in their annual report, directed towards the needs of their primary users. Financial statement not only looks different but report different information depending on the primary user group. Moreover, even if companies in different nations orient their financial statements toward similar user groups, there are still likely to be differences in accounting practices and in the way that the annual reports appear.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define transnational financial reporting and explain what has caused the phenomenon.
2. Discuss problems confronting users of foreign financial statements.
3. State and explain what multinational corporations do to accommodate foreign readers of their financial reports.

3.0 Main Content

3.1 TRANSNATIONAL FINANCIAL REPORTING

Transnational financial reporting refers to reporting across national boundaries or more specifically, reporting financial results to users groups located in a country other than the one where the company has its headquarters. A Nigeria company is engaged in transnational financial reporting whenever it sends an annual report to a citizen of another country. If you write to a German company and receive its annual report, transnational financial reporting has occurred.

Transnational financial reporting has been encouraged by two phenomena. The first may be termed the global financing strategies of multinational corporations. Global financing includes:

1. Listing a company's capital stock on stock exchanges outside the home country.
2. Selling bonds in various countries, and
3. Arranging for loans with foreign banks.

Multinational corporations no longer look exclusively to the stock markets, bond markets and banks of their respective home countries to raise capital. They go wherever the money is most available and cheapest.

The second phenomenon is transnational investing. Those with funds to invest buy the stocks and bonds of foreign companies in addition to those in their own nation. Thus, the multinational corporation and the shareholders/creditors are responsible for this twin phenomenon.

SELF ASSESSMENT EXERCISE
What is transnational financial reporting?

3.2 INVESTORS PERSPECTIVE OF FOREIGN FINANCIAL REPORT

When a company prepares a financial report for users in its own country, it can reasonably assume that the users understand

1. The general orientation of financial accounting in that country.
2. The particular accounting practices that the company employs.
3. The language in which the annual report is written and
4. The currency unit used to present the financial statements.

However, any or all of these four items may be different when a company sends a financial report to users in another country. Suppose that a friend of yours suggests that you should invest in a company in Germany. In looking at the financial statements, you also notice that all of the amounts are expressed in deutsche marks (DM). The report looks different from Nigeria companies' reports, so you may also suspect that the company uses German accounting practices. Unless you can read German, know German accounting practices, and are familiar with German currency, you will probably have a difficult time understanding that company's annual report. Consequently, you may decide not to invest in that company since it would be "too much trouble" to extract the information you need from the annual report. You may very well pass up a good investment opportunity, although you will never know it. Of course, you may also take other courses of action. One would be to get someone to translate the report into English, while you learn all you can about German accounting practices. At a minimum, this choice would be time-consuming and even cost you money if you had to pay someone for the translation. And having done this, the accounting information would still not be directly comparable to that of a Nigeria company. In most cases, it is impossible for a user to restate financial accounting information so that it conforms to the accounting practices of another country.

Another course of action is to forgo trying to understand the company's annual report and instead rely on the advice of an expert, such as a stockbroker. Many accountants are concerned about the effects that an unfamiliar language, monetary unit, and accounting practices may have on investors and creditors. They fear that resource allocation decisions may be based on misunderstanding and as a result, that these decisions may not be optimal. This is one reason why accountants are trying to harmonize accounting practices around the world.

SELF ASSESSMENT EXERCISE

When a company prepares a financial report for users in its own country, what can reasonably be assumed that the users should understand?

3.3 PRESENTATION OF FINANCIAL REPORTS BY MULTINATIONAL CORPORATIONS

Multinational corporations have a role to play in trying to minimize misunderstanding of financial statements sent to users in foreign countries. We can classify five approaches that multinational corporations take to accommodate foreign readers of their financial reports:

1. No action approach.
2. Prepare convenience translations.
3. Prepare convenience statements.
4. Restate on a limited basis.
5. Prepare secondary financial statements.

No Action Approach

A corporation sends the same financial statements to the foreign user. The financial statements are written in the native language and use the native currency unit and accounting principles. This approach puts the entire burden of understanding the financial report on the user, and it more or less assumes that the report for readers at home is useful to readers in other countries as well.

Why would a corporation choose to seemingly ignore the information needs of its foreign readers? First of all, if the company raises very little capital outside the borders of its home country, the added expense of taking one of the other four approaches may not be worthwhile. Second, some multinationals are able to entice international investment in their securities even though they leave their financial statements in their original form. One way they accomplish this is by selling large blocks of their securities directly to sophisticated overseas investors, such as pension funds (such sales are called private placements) or they may meet directly with investment firms to encourage the firms to recommend investments in their securities. Large investment firms, especially, employ analysts who are skilled at interpreting financial statements in their original form. Either way, these multinational corporations attempt to attract foreign investors without incurring the extra costs associated with the other forms of transnational financial reporting. A third reason why a multinational corporation may choose to do nothing is that the language, currency unit, and accounting principles of its home country are well known and understood around the world.

Prepare Convenience Translations

Convenience translations are financial statements translated into the foreign reader's language. They retain the home country's accounting principles and currency unit. This approach is relatively inexpensive accommodation to the foreign readership. Companies taking this approach typically prepare English, French, Germany and perhaps, Spanish language versions (as appropriate) of their annual reports. The user is saved the bother of dealing with an unfamiliar language but must still understand another country's accounting practices and monetary unit. Companies usually prepare convenience translations in order to enlarge the scope of shareholders/creditor's interest beyond the borders of their home country, and they are a low-cost alternative to the no-action approach. For this reason, convenience translations are also commonly used with private placements or to attract the attention of foreign investment firms.

Prepare Convenience Statements

This approach takes convenience translation one step further. Not only are the financial statements translated into the language of the foreign readers, the monetary amounts are also expressed in the reader's currency. However, the accounting principles of the home country are still used to prepare the financial reports. An exchange rate is simply how much of one currency it takes to buy so much of another currency.

Convenience statements often lose much of their foreign appearance, and unless users realize that another country's accounting principles are used, they will be misled into thinking that the financial statements can be directly compared to those of companies of their home country. Naturally, readers can comprehend their own language and currency better than those of another country, but they must still be able to understand the accounting practices used in the company's home country in order to derive actual meaning from the annual report.

Restate on a Limited Basis

This approach represents a significant step toward accommodating the information needs of foreign readers compared to the first three. Normally, a company reconciles the net income amount shown on its income statement (prepared using its home-country accounting principle) to a net income amount based on the accounting principles of the reader's country, and often the company restates the balance sheet figures as well. However, sometimes a company restates only selected financial statement items. The annual report is typically written in the reader's language, but the currency is still that of the company's country.

Companies adopting this approach feel a clear need to communicate with their foreign annual report users. If a significant number of shareholders or creditors is located in other countries and if the company's accounting practices diverge significantly from those found in the reader's country, then the need is real. Companies following this approach must keep more than one set of accounting records. Fortunately, computerized accounting systems can significantly reduce the cost and convenience of this approach.

Prepare Secondary Financial Statements

This approach represents a further accommodation to the users of a company's financial statements. Companies continue to prepare their primary financial statements for the home user with the home country's language currency, and accounting principles. For foreign readers, however the company completely restates its financial report to conform to another set of accounting standards.

In practice, the other set of accounting standards used most often is either the generally accepted accounting principles of the United States or the standards of the International Accounting Standards Committee are the most detailed and extensive in the world and they are generally regarded as "world class" in quality. Consequently, many multinationals choose US GAAP when they prepare their secondary financial statements. However, the IASC is increasingly accepted as the voice for acceptable world-wide accounting standards. Secondary financial statements are meant for sophisticated worldwide users. What makes a company go so much trouble to accommodate the foreign reader? As with the previous approaches, it all comes down to whether the perceived benefits exceed the cost. Multinationals preparing secondary financial statements are normally from countries where accounting is legalistic in its orientation. For them, the fair presentation/full disclosure model of accounting with its emphasis on presenting useful information to shareholders and creditors is more likely to attract widespread international investment than is their home country's legal compliance model of accounting.

SELF ASSESSMENT EXERCISE

Mention and explain five approaches that multinational corporations take to accommodate foreign readers of their financial reports.

4.0 CONCLUSION

It should be noted that financial practice and business decision making differ around the world, and readers of foreign financial statements must understand how the business environment in a corporation's home country affects the firm's financial reports. This is especially critical if the user is comparing the accounting numbers of companies from different cultures.

One devise used to analyze financial reports is ratio analysis. Ratios of key items on the financial statements are calculated to determine such things as riskiness, ability to pay off debts and profitability.

5.0 SUMMARY

In this unit, we were able to define transnational financial reporting and what has caused the phenomenon. We discussed investors' perspective of foreign financial report and the presentation of financial report by multinational corporations. We have discussed the problems confronted by financial statement users when they are provided information that is not in their native language, their native currency or prepared according to accustomed accounting principles. We have also discussed what corporations do to help foreign financial statement users overcome these problems.

6.0 TUTOR MARKED ASSIGNMENT

1. Define transnational financial reporting and explain what has caused this phenomenon.

2. What are the problems confronting users of foreign financial statements.

3. State and explain three steps multinational corporations take to accommodate foreign readers of their financial reports.

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 1: THE MULTINATIONAL CORPORATIONS

CONTENT

1.0 INTRODUCTION

You must have come across the words multinational corporations being used in previous units in this study material. This is because you cannot discuss international accounting without discussing multinational corporations due to the fact that multinational corporations are major player in the phenomenon of international accounting. Therefore, it is in the light of this unit to discuss issues relating to multinational corporations.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain what a multinational corporation is and distinguish between a traditional multinational corporation and transnational corporation.
2. Explain the motives for direct foreign investment.
3. Discuss the international perspective on consolidated financial statements.

3.0 MAIN CONTENT

3.1 WHAT IS A MULTINATIONAL CORPORATION?

A multinational corporation (MNCs) or multinational enterprise (MNE) is a corporation enterprise that manages production or delivers services in more than one country. It can also be referred to as an international corporation.

The International Labour Organization (ILO) has defined an MNC as a corporation that has its management headquarters in one country, known as the home country and operates in several countries known as host countries.

Some multinational corporations are very big, with budgets that exceed some nation's gross domestic products (GDPs). Multinational corporations can have a powerful influence in local economies, and even the world economy and play an important role in international relations and globalization.

It is important to distinguish a transnational corporation (TNC) from a traditional MNC. A transnational corporation differs from a traditional MNC in that it does not identify itself with one national home while traditional MNCs are national companies with foreign subsidiaries. TNCs spread out their operations in many countries sustaining high levels of local responsiveness. An example of TNC is Nestle who employ senior executive from many countries and try to make decisions from a global perspective rather than from one centralized headquarters. However, the terms TNC and MNC are often used interchangeably.

SELF ASSESSMENT EXERCISE
What is the difference between multinational corporations and transnational corporation?

3.2 MOTIVES FOR DIRECT FOREIGN INVESTMENT

New MNCs do not pop up randomly in foreign nations. It is the result of conscious planning by corporate managers. Investment flows from regions of low anticipated profits to those of high returns.

1. Growth motive- a company may have reached a plateau satisfying domestic demand, which is not growing. Therefore, proceed to looking for new markets.

2. Protection in the importing countries- foreign direct investment is one way to expand bypassing protective instruments in the importing country. For example, European community imposed common external tariff against outsiders. US companies circumvented these barriers by setting up subsidiaries.

3. Market competition- the most certain method of preventing actual or potential competition is to acquire foreign businesses.

4. Cost reduction- cheap foreign labour. Labour costs tend to differ among nations. MNCs can hold down costs by locating part of all their productive facilities abroad.

SELF ASSESSMENT EXERCISE
What are the motives for direct foreign investment?

3.3 INTERNATIONAL PERSPECTIVE ON CONSOLIDATED FINANCIAL STATEMENTS

Like you would recall, consolidated financial statements combine the separate financial statements of two or more companies to yield a single set of financial statements as if the individual companies were really one. Multinationals are often required by the countries in which they do business to set up a separate corporation in each country. The point is that a legal entity is not necessarily the same as an economic entity. From an economic point of view, the activities of these various legal entities are centrally administered from corporate headquarters. Thus, the intent of consolidated financial statements is to provide financial accounting information about the group of companies from an overall perspective.

Consolidated financial statements first appeared around the turn of the 20^{th} century in the United States. This was a time of great economic expansion during which a number of corporations grew into economic giants. The era witnessed a wave of corporate mergers. It is said that J.P. Morgan was so proud of his US steel company (the first billion-dollar company in the world) that he insisted on preparing and disseminating consolidated financial statements since the company's inception in 1901. Since holding companies first became important in the United States, it is not surprising that US accountants were the first to experiment with consolidated financial statements. These statements are now a part of US generally accepted accounting principles.

Holding companies became important in Great Britain and Netherlands in the 1920s, so consolidated financial statements appeared there somewhat later than in the United States. Today, they are required in both countries. The practice moves much more slowly in the other European countries.

SELF ASSESSMENT EXERCISE
A legal entity is not the same thing as economic entity, explain.

4.0 CONCLUSION

Some argue that ownership is a key criterion. A firm becomes multinational only when the headquarters or parent company is effectively owned by nationals of two or more countries. For example, Shell and Unilever, controlled by British and Dutch interest are good example. However, by ownership test, very few multinationals are multinational. The ownership of most MNCs is uni-national. Therefore, ownership does not really matter.

5.0 SUMMARY

In this unit, we discussed the multinational corporations. We discussed what a multinational corporation is and what the motives that drive direct foreign investment are. We also discussed the international perspective on consolidated financial statements.

6.0 TUTOR MARKED ASSIGNMENT

1. What is a multinational corporation?

2. Explain the motives for direct foreign investment.

3. Discuss the international perspective on consolidated financial statements

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 2: INTERNATIONAL FINANCIAL STATEMENT ANALYSIS

CONTENT

1.0 INTRODUCTION

Assuming you had just been recently hired as a financial analyst for a major Nigeria multinational corporation. And you are required to carry out analysis from a set of financial statements from a Japanese corporation which your company intended buying over because of its sustained growth and profitability. As the company comes so highly recommended, you assume it will be a routine exercise to generate the supporting members to back up the purchase decision.

Assuming you discovered that the Japanese company is a financial disaster. Its debt to equity ratio is nearly twice as large as that of Nigeria firms. Contributing to your worries is short-term debt nearly double that of Nigeria firms. In addition, the net income numbers are very low compared to what you expected for this growing firm. And you are wondering what could be wrong selecting such a company for acquisition. That is the essence of this unit, that a framework should be developed that uses information to analyze a foreign based corporation's financial position in the light of the environment in which it operates.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain how cultural values influences accounting system.
2. Discuss the following accounting values
    a. Professionalism versus statutory control

b. Uniformity versus flexibility

c. Conservatism versus optimism

d. Secrecy versus transparency

3.0 MAIN CONTENT

3.1 FINANCIAL ACCOUNTING REFLECTS THE ENVIRONMENT IT SERVES

The use of home country ratio analysis expectation for analyzing foreign financial statements is only effective if the foreign financial accounting system and the operating environment closely parallel that of the home country. Unfortunately, that is rarely the case. Each country's national financial accounting system evolved to serve the needs of its domestic environment and in particular, the needs of the users of accounting information in that country. Therefore, each country's national financial accounting and reporting requirements are different. The best way to properly analyze financial statements from another country is to understand the domestic accounting system and business practices in that country.

Becoming familiar with each country's accounting and business practices is a monumental task. However, we have the necessary tools. We need to develop an approach, that is, a framework that can be use with any country.

SELF ASSESSMENT EXERCISE
Explain what you understand by financial accounting reflects the environment it serves.

3.2 A FRAMEWORK FOR FINANCIAL STATEMENT ANALYSIS

This sub-unit explains the framework for analyzing financial statement, as seen in the light of the culture, accounting values and accounting systems existing in both countries of comparison, that is, the home country and host countries.

CULTURE VALUES

The accounting system is also influenced by culture and the values that a society shares. Knowing something about a people's values can help us understand their accounting system. Values are defined as a tendency to prefer a certain state of affairs over another. For instance, people in the United States value the concept of individualism, whereas in Japan it is not the individual who is important but how the individual relates to the group. Japanese culture maintains a strong degree of interdependence among individuals. Group norms are far more important than a single individual's opinion or professional judgment. The Japanese society accepts that there is a natural hierarchical order in which each person has a role that is not questioned. In the United State, it is not accepted that power is distributed unequally. In fact, people having equality are demanded.

Another cultural difference between US and Japan is how a society feels about uncertainty and ambiguity. A culture that prefers less uncertainty depends on institutions to maintain conformity, and deviating from the norm or the rule is discouraged, as in Japan. Rules make people comfortable because the rule prescribes what to do in any circumstance, thus, removing the uncertainty and need for judgment. The opposite is a society that values practice more than principles and allows for the exception to the rule, as in the United States and the United Kingdom.

ACCOUNTING VALUES

The following accounting values are not meant to be exhaustive, but are offered as representative of values that influence the development of national accounting systems and measurement and disclosure practices:

1. Professionalism versus statutory control
2. Uniformity versus flexibility
3. Conservatism versus optimism
4. Secrecy versus transparency

PROFESSIONALISM VERSUS STATUTORY CONTROL

Accounting values include a preference for independent professional judgment as opposed to statutory control. A preference for exercising professional judgment is consistent with a preference for individualism and subjectivity, which we find in the accounting systems of countries listed in the fair presentation/full disclosure model. The United Kingdom values the concept of presenting a 'true and fair view' of a company's financial report, and the auditor is given the right to use professional judgment to accomplish this goal. This is also the case of Nigeria. Statutory control or compliance with prescriptive legal requirements is an accounting value of both the legal compliance and inflation-adjusted models. In Japan, France and Germany, accountants follow legal rules and exercise much less judgment than in the United Kingdom.

UNIFORMITY VERSUS FLEXIBILITY

A second set of accounting values that influence financial reporting systems is uniformity versus flexibility. A society that values uniformity shows a preference for the enforcement of a uniform accounting practices, whereas a society that values flexibility takes into account the circumstances of individual companies. There is a link between this accounting value and the cultural value of dealing with uncertainty that we discussed in the prior section. Uniformity is found in the accounting practices of the code law legal compliance and inflation-adjusted models. Flexibility is exhibited by the countries in the common law fair presentation/full disclosure model. Once again, we see a difference between Japan and the United States. Japan's accounting system is influenced by uniformity while flexibility prevails in the United States.

CONSERVATISM VERSUS OPTIMISM

The accounting value of conservatism relates to the measurement of accounting information and manifest s itself in a preference for a cautious approach to measurement as a way to cope with the uncertainty of future events. Optimism tolerates more uncertainty in measurement practices. To illustrate, many expenditures made by a company are expected to benefit future periods. Of course, the benefit is uncertain. Should these expenditures be expensed immediately, or should they be shown as an asset and charged to expenses in future periods? Conservatism calls for the former, while optimism would allow the latter in certain situations. Countries in the fair presentation/full disclosure model take a more optimistic approach to measurement than do those countries of the legal compliance and inflation-adjusted models. The difference in approach has been attributed to different providers of capital and the demands of different users as well as the influence of tax laws. For example, Japanese financial accounting is strongly influenced by the tax law, which leads to more conservative measurement practices in order to minimize taxes.

SECRECY VERSUS TRANSPARENCY

The last set of accounting values we discuss here is secrecy versus transparency in regard to disclosure practices. The countries of the legal compliance and inflation-adjusted models show a preference for confidentiality and tend to restrict disclosure of information to management and those who provide the business financing. Secrecy and conservatism are related in that both result in a more cautious approach to reporting, as is seen in Japan. The fair presentation/full disclosure model countries disclose more information and take a more publicly accountable approach to financial reporting, which are their response to the providers of capital being private investors.

SELF ASSESSMENT EXERCISE

Explain the accounting value uniformity versus flexibility.

4.0 CONCLUSION

Knowing something about a country's accounting values helps us to interpret and understand the financial reports of companies operating in that environment. The goal is to be able to realistically analyse the financial reports of any multinational corporation, given the national accounting and business practices that evolved from the operating environment.

5.0 SUMMARY

In this unit, you would recall that the unit is focused on international financial statement analysis. The topic was discussed in two sub-units which are financial accounting reflects the environment it serves and a framework for financial statement analysis.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain how cultural values influence accounting system.

2. Discuss the following

   a. Professionalism versus statutory control

   b. Uniformity versus flexibility

   c. Conservatism versus optimism

   d. Secrecy versus transparency

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 3: INFORMATION SYSTEMS FOR MULTINATIONAL PLANNING AND CONTROL

CONTENT

1.0 INTRODUCTION

We live in the information age. The integration of the telephone, the computer and television is producing the 'information highway'. Information feeds management decision making and control. In international business operations, the information system provides the information that the multinational corporation (MNC) needs to plan, control, evaluate and coordinate all of its business activities.

Managers at all levels in the MNC need internally developed and reported information to monitor and improve their decision making. MNCs information system must incorporate and report changes in the economic and political environments, legal constraints, cultural and sociological differences in each country of operation. This information is generally provided by the subsidiary managers.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Gain familiarity with the nature of business information systems and the functions they perform.
2. Identify communication problems that challenge the effectiveness of the MNC planning and control system.

3.0 MAIN CONTENT

3.1 MNC AFFECTS THE INFORMATION SYSTEM

An MNC has various levels of managers with varying degrees of authority and responsibility. The distribution of these management levels constitutes the MNC organizational structure and determines what information each level needs to plan and control its operations. The information needs define how the data are collected and processed within the information system. Therefore, the structure of data collecting, processing and reporting within an information system ought to parallel and complement the organizational structure of the MNC.

The classic multinational company has operated as a decentralized unit with the ability to respond to national and local differences and opportunities. The traditional global company has managed operations by tightly controlling its worldwide subsidiaries through centralization. Today's companies must be local and global, that is, transnational. The transnational company must operate efficiently and economically through global-scale operations. It must be able to respond to both national and local differences, retaining local flexibility while achieving global integration. The innovative company that can transfer knowledge quickly and efficiently by linking operations to each other will survive. Never before has the design of the information system been so critical to the success of the transnational company. Information processing and technology transfer systems between parent and subsidiary and among the subsidiaries must be flexible and shared. Companies that can develop this transnational organizational capability will have the key to long-term success.

SELF ASSESSMENT EXERCISE
How does Multinational Corporation affect the information system?

3.2 COMMUNICATION PROBLEMS IN MNCs

1. Differences in Measurement and Disclosure Practices

Accounting measurement, disclosure, and reporting practices vary a great deal across geographic boundaries. In many countries, accounting is not well developed and reporting practices are not as defined as those in the United States. However, for effective control, an MNC needs an internal reporting system with standardized, consistent and uniform accounting principles and practices. Ideally, all subsidiaries should use comparable accounting practices. Assets and liabilities should be valued and reported according to a common plan. Expense recognition should be consistent from year to year (e.g each subsidiary should use the same depreciation method from year to year). All domestic and foreign managers should understand how headquarters defines the word 'profit'. All domestic and foreign subsidiaries of US based MNCs should use US generally accepted accounting principles for reporting back to corporate headquarters. Consistency and uniformity are particularly important when the information is used to compare one subsidiary's performance to another.

2. Ease of Communication

Geographic proximity is also a consideration in terms of facilitating the flows of information back and forth between the subsidiaries and headquarters. For example, a US based MNC would probably find it easier to communicate to a subsidiary in Mexico than one in Chile, simply because the Mexican subsidiary is physically closer. Traditionally, MNCs have transmitted information by mailing paper documents or making phone calls. However, these are giving way to electronic forms of communication (such as e-mail). Electronic communication reduces the amount of time it takes for a parent company to communicate with a distant subsidiary (and vice versa) and in many cases makes it nearly instantaneously. Even so, communication across borders can still be difficult. In many MNCs, computer systems are not compatible worldwide. The sheer rate of technological change poses problems for keeping employees up-to-date in using new technology. Cultural barriers can also cause difficulties. Nevertheless, innovations in electronic communication will simplify and improve how MNCs send information around the world.

3. Financial and Operating Information for Internal Reporting

Many firms equate volumes of reports with good financial control. However, subsidiaries' local management may complain that the volume of required reporting hampers its ability to cope with daily operating problems. In fact, local management is responsible for reporting financial data to the parent and operating the subsidiary successfully. Therefore, the problem is to identify the relevant information that top management needs to maintain the planning and management control systems. This is difficult to achieve. In fact, several studies have shown that MNC headquarters may require a single subsidiary to submit over 200 different financial reports annually. Even with this many reports, there is no assurance that the MNC is well managed.

4. Goal Congruence

Most major companies in the United States use the profit centre or investment centre concept for domestic control systems. This approach works relatively well domestically because profit centre managers make the major decisions affecting their centre's performance. Good decision making ensures good performance evaluation, and good performance evaluation ensures good decision making. The goals are congruent because authority and responsibility are delegated to the same people. Managers are evaluated based on the performance that results from their decisions. Manager performance and profit centre performance are linked.

International operations do not lend themselves to management control systems based on a profit centre concept. Foreign subsidiary profits are often somewhat manipulated to facilitate paying the somewhat manipulated to facilitate paying the smallest possible amount of income taxes on a worldwide basis. Or by manipulating the prices at which goods are transferred into a country, an MNC can minimize the import duties paid. Each scenario affects a subsidiary's reported profit. Therefore, using the strict profit centre is inappropriate.

For the profit centre idea to work effectively, subsidiary managers must have the authority to make all decisions affecting their profits. Yet many MNCs maintain centralized control over subsidiaries, and many decisions are made at headquarters. Foreign managers may have responsibility for operations, but they do not have the authority to make major decisions affecting their profitability. Such a situation does not have the authority to make major decisions affecting their profitability. Such a situation does not enhance goal congruence. Regardless of the situation, some degree of responsibility and authority should be provided to subsidiary mangers so that they remain responsive to their local environment.

SELF ASSESSMENT EXERCISE

Explain three communication problems in Multinational Corporations.

4.0 CONCLUSION

Planning defines a company's objectives and provides a strategy to achieve them. Such plans require a management control system as well as a performance evaluation system. The management control system should complement the plan so that the goals of the international managers are congruent with the overall goals of the MNC.

5.0 SUMMARY

In this unit, we discussed information systems for multinational planning and control. The topic was discussed in the light of two sub-units which are MNC affects the information system and communication problems in MNCs.

6.0 Tutor Marked Assignment

1. Explain the nature of business information systems as it relates to MNC.

2. Identify and explain the communication problems that challenge the effectiveness of the MNC planning and control system.

7.0 REFERENCES/FURTHER READING

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 4: MULTINATIONAL BUDGETING SYSTEMS

CONTENT

1.0 INTRODUCTION

The budgeting process for a multinational company is basically not different from that for domestic operations, except that it must recognize diverse environments as well as the addition of the impact of currencies. The currency factor is perhaps the most visible difference between domestic and multinational budgeting. It requires the forecasting of exchange rates for, first establishing capital budgets and profit plans and second, controlling them later on.

In the light of that we shall be discussing forecasting exchange rates, basic approaches to capital budgeting and planning, and building the capital budget.

2.0 OBJECTIVES

After studying this unit, you should be able to

1. Explain the fundamental and technical approaches.
2. Explain what are the basic approaches to capital budgeting and profit planning.
3. Discuss the steps involved in building the capital budget.

3.0 MAIN CONTENT

3.1 FORECASTING EXCHANGE RATES

Briefly stated, forecasting technique follow either the traditional, fundamental approach or the more recent technical approach.

1. **Fundamental Approach**- The fundamental approach has evolved from classical economics. In applying this technique, management (usually the treasurer) assesses certain economic and socio political variables of a nation to predict the economy's performance and how such performance will affect the supply of, and demand for and demand for that nation's currency.

   Economic variables include domestic monetary and fiscal policy, inflation rates, unemployment, development of natural resources, international trade competitiveness, and capital flows, socio-political variables include the general attitude of government and population towards the private business sector, the system of government, its involvement in the commercial sector, labour relations, and the degree of political stability. The forecaster must also be aware of the sensitivity of each variable and its relative importance with respect to the time horizon projected. Relevant variables should be forecast for the times of interest to management in the budgeting process, for example one, three or five years.

2. **Technical Approach**- Technical analysis has developed from the study of international money market behaviour in an attempt to predict cyclical trends in the demand and supply of individual currencies. This forecasting technique concentrates more on predicting the timing of exchange rate movements than on the underlying fundamentals per se. By forecasting when a shift in currency values is expected the user of technical analysis expects to be in a position to hedge accordingly. Technical analysts often postulate that the market adjusts too swiftly to changes in fundamental variables to make a forecast based on fundamentals meaningful. They argue that it is best to observe the signals which mark a change in market mentality and to climb on board before the market leaves them behind. Fundamentalists have often argued that this game plan is little better than the "school of fish" theory, which states that a fish is best protected if it swims with the main stream and in the centre of the school out of a predator's reach.

   From a practical point of view, management must decide whether it wants to forecast exchange rates on the basis of one of the aforementioned theories or whether it concludes that exchange rates cannot be forecast and that, the current exchange rates (at the time of initiating a particular budget cycle) should be used for the forward period.

SELF ASSESSMENT EXERCISE
Explain the fundamental and technical approaches.

3.2 BASIC APPROACHES TO CAPITAL BUDGETING AND PROFIT PLANNING

When examining the methods and procedures used for capital budgeting and profit planning, we find two approaches: top-down and bottom-up.

If the corporate level determines the perimeter of the capital budget, the total amount of dollars to be spent and then apportions to division, regions and affiliates, this constitutes a top-down approach. If, conversely, the corporate level asks the affiliates to determine their capital requirements and proposed net income and the regions and divisions merely aggregate the affiliates' proposal, we refer to this process as a bottom-up approach.

In practice, these two approaches are frequently combined. At the corporate level, the overall perimeters will be determined.

3.3 BUILDING THE CAPITAL BUDGET

a. Objectives- Prior to the establishment of a capital budget, it is important that the company determine its long-range objectives and prepare a strategic plan that specifies timing horizons and overall capital requirements. In a multinational company, objectives and capital needs are then suggested for each country and each major affiliate or function within the countries.

b. Annual and Total Requirements- Frequently, a negotiating period is needed during which the corporate level negotiates with the division, the division with the region, and, finally, the region with the affiliates what capital projects will eventually yield the desired objectives. To enable the affiliates to do the necessary preparatory work, two dimensions of all proposed capital projects are considered. The total cost of the project and the timing of cash expenditures to complete the projects. For purposes of capital budgeting, the total cost, which may stretch out over several years is included; for purposes of cash budgeting, the annual funds required are essential to determine the annual overall financing aspects.

c. Interface between Objectives and Capital Budget- It is desirable, but not absolutely necessary, to prepare objectives for a three or five year period in sufficient detail, that is, stating requirements for each major program or projects, so that the first forward year's data can- and frequently do- from the capital budget for that year. The remaining years of the objectives will then represent preliminary indications, which will be fleshed out in subsequent cycles.

d. Determination of Exchange Rates- The reason for making year 1 of the objectives the capital budget for the year is the complexity caused by the need to set the exchange rates for each country's use in the objectives and capital budgeting process. It is recommended that the exchange rates be fixed at the beginning of that process; otherwise, a lot of time will be consumed in arguments between a region and affiliate as to which rate is to be used for what purpose.

SELF ASSESSMENT EXERCISE
State and explain the steps in building capital budget.

4.0 CONCLUSION

Capital budgeting and profit planning in a multinational environment are not fundamentally different from those for domestic operations. The two factors: nationalistic and currency aspects matters do not apply to purely domestic operations. The nationalistic factors mean the legal and behaviour elements that are present in dealing with operations in other countries.

5.0 SUMMARY

In this unit, we discussed multinational budgeting systems considering forecasting exchange rates, basic approaches to capital budgeting and profit planning and building the capital budget.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the fundamental and technical approaches.

2. What are the basic approaches to capital budgeting and profit planning.

3. Discuss the steps in building the capital budget.

7.0 REFERENCES/FURTHER READING

Choi, F. D. S and Lewis, G. F. (2003)," Multinational Budgeting and Control Systems." In International Finance and Accounting Handbook, New York: John Wiley & Sons.

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MODULE 3: ISSUES WITH MULTINATIONAL CORPORATIONS

UNIT 5: MULTINATIONAL CONTROL SYSTEMS

CONTENT

1.0 INTRODUCTION

In the previous unit, we discussed multinational budgeting systems. Let us go further by discussing multinational control systems. A control system is a device or set of devices to manage, command, direct or regulate the behaviour of other devices or system. Multinational control systems are the management control systems adopted by large business group to manage the relationship within the group and monitor their work in order to improve the performance of the entire group. It is a means of gathering and using information.

We shall be discussing this topic under the following sub-units; controlling the capital budget; building the profit plan and profit planning controls.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define a multinational control system.
2. Discuss budget controls, fixed exchange rates, current exchange rates and assessment of alternative approaches.
3. Explain income forecasting and development of the profit plan.
4. Discuss the use of variance analysis in profit planning controls.

3.0 MAIN CONTENT

3.1 CONTROLLING THE CAPITAL BUDGET

a. Budget Controls- In controlling capital budgets, it is customary to examine three aspects of the budget periodically, say quarterly: the capital budget itself, appropriations against the capital budget (how much of the budget was authorized for actual implementation), and capital budget expenditures. Controls of capital expenditures are a function of the corporate treasurer overall cash controls, which are not related to the capital budgeting process per se.

b. Fixed Exchange Rates- This represents a control approach that stresses parent company (including division and region) emphasis on the total company budget, with relatively weak control needs over local variances due to fluctuating exchange rates. This indicates where appropriations against the budget use the same exchange rate for both parent company and foreign subsidiaries. Some items in the foreign subsidiaries could be under appropriated while some others could be over appropriated. However, normal expectations are that budgets, in total, will not be over appropriated. Internal company control procedures usually specify whose approval is required to authorize such local company over appropriations; up to a certain level, no higher-level authorization may be needed. If, however, the local currency exchange rate assumption, higher-level authorization normally would be required.

c. Current Exchange Rates- A different control environment exists if the parent company wants to exercise more direct controls over an affiliate's budgets, including all the vagaries of changing exchange rates. In that case, the budgeted exchange rate is used for the capital budget only, while appropriation (like expenditures) is recorded as the exchange rate in force on the day, or in the month, of recording the appropriation.

This approach has the advantage of coming somewhat closer to real "actual" data, but it has the disadvantage that budgets have to be adjusted and projects may have to be abandoned solely because of shifts in the exchange rate. The difference between the two control approaches depends, of course, upon the degree and frequency of exchange rate exchanges.

d. Assessment of Alternative Approaches- No preference can be expressed for one or the other alternative control approach. Capital budgets represent intended capital programme. Other considerations entering into a decision regarding which control procedure to use include the sources of financing and actual capital expenditures. If financing normally takes place in the parent company country and funds are sent to the affiliate, the former approach- freezing the exchange rate- may be an adequate and simpler procedure. If the affiliate is essentially self-financing, reporting budget appropriations at current rates rather than fixed exchange rates provides a more accurate and meaningful presentation; moreover, in dealing with hyperinflationary countries, a fixed exchange rate approach is entirely unrealistic and leads to distorted results.

SELF ASSESSMENT EXERCISE
Explain fixed and current exchange rates.

3.2 BUILDING THE PROFIT PLAN

a. Income Forecasting: The profit plan. A full set of objectives contains not only capital projections for the next three to five years but also income levels and cash flow forecasts, hence the need to discuss income forecasting.

While it is appropriate and time saving to use the first year of the objectives as both the starting and ending point for the capital budget, this approach does not work equally well for the profit plan or operating budget. A top-down/bottom-up dialogue was used to pass down guidance from the corporate level via division and region to the various affiliates, with the affiliates building up the details of capital projects and programmes to 'meet' the corporate guidelines. The affiliates, no doubt, participated in establishing income levels in the objectives, but other than agreeing on board economic perimeters- revenues, total costs and expenses, margins, taxes, and the resulting net income- a detailed build up of all data does not normally occur.

b. Development of the profit plan- in building profit plan for the next year, it is important to establish the reasons for this exercise. The profit plan is frequently used as a target for, and commitment by, management. It is a vital forecast for the company's cash management, overall operating decisions, and maximizations of intra-corporate transactions, and it frequently serves as a yardstick against which bonuses are calculated. It is therefore, necessary to be as specific as possible within each affiliate when establishing underlying assumptions. It is often advisable to start literally from the bottom up, that is, involving the lowest level of the organization in determining realistic estimates for such data as volumes, prices, new products, and recurring and non-recurring expenses, which in turn, may be variable or non-variable (fixed), and so on. Also, the likely economic conditions cfor each country and sometimes for areas within a country- as well as income and other tax rates must be established by the various levels within each affiliate's organization. These assumptions are then presented to region management for its concurrence or suggested changes. As was the case in establishing capital budget details, there is an almost continuous negotiation process going on to make sure that region and affiliates think along the same lines.

SELF ASSESSMENT EXERCISE
Explain the term "development of the profit plan".

3.3 PROFIT PLANNING CONTROLS

Throughout the year, control reports are prepared at intervals required by the various levels of management and the corporate parent. A step in profit planning controls is income comparison. It could be discovered that income difference between the parent company and foreign subsidiaries could be attributed to currency factors. Therefore, the parent company would proceed to performing some variance analysis to separate the currency factor from one or more operating factors.

Variance analysis can be made relatively simple, or it can be extended to include detailed and sophisticated approaches, depending upon the requirements of managements. The two most common variances used by financial analyst are volume and price variances. We need these to analyze both revenues and costs, and the method is the same whether we deal with realizations or cost of sales. One way of arriving at a volume variance in revenues is to multiply the change in sales volume by the unit selling price of the base period. Similarly, when we wish to establish the volume variance arising out of costs, we multiply the change in cost volume by the base period's unit cost. The base period is the period against which we make our comparison, be it the prior year, the prior month of the profit plan.

To arrive at the revenue price variance, we take the change in selling price and multiply it by the current period's volume. The cost price variance is computed similarly; the change in unit cost is multiplied by the current period's volume. It is more descriptive to call the price variance, relating to cost of sales, a cost rate variance.

The foregoing variances give us the explanation as to what happened to the margin or gross profit realized in our business. In the simplest variance analysis, one more aspect needs to be accounted for: expenses. The easiest method is to compare current period expenses with those of the comparison period and call the result an expense variance.

The methodology provides only a very basic variance analysis. More sophistication is frequently desirable and necessary. The price variance relating to revenues can easily be broken down into variances arising from price changes at the port of entry and the prices achieved at the final destination. Similarly, the volume variances can be divided between a true volume variance and the variance which arises from a change in the mix of products sold. A more elaborate variance analysis approach will include the change in volume-related expenses as part of the volume variance. The cost rate variance can be calculated in such a way that management can ascertain the effect of a cost rate change based on current or replacement costs, segregating them from those which are due to the vagaries of the inventory valuation system. Finally, the expense variance can be made more useful by differentiating between fixed expenses, maintenance, gain or loss on exchange, gain or loss on the sale of assets, and so forth. We use only the four basic variances (volume, price, cost rate and expenses).

SELF ASSESSMENT EXERCISE
What are the most common variances used by financial analyst?

4.0 CONCLUSION

There must be a clear-cut organizational structure from the parent company at the top to the operating functions of each affiliate at the bottom. There has to be a strong communication link between the various levels to search out ideas, reach appropriate conclusions, and arrive at capital spending and income levels that straddle the fine line between the availability of funds and the generation of new cash sources via the income route. Capital budgets and profit plans must be put together and fully understood in both the parent company's currency and that of each affiliate. There must be adequate reference points to enable all management levels to establish periodic controls; in the capital budgets, major projects or projects or programs should be listed; the profit plan should display the results of specific volume, price and expense targets, to mention just a few.

5.0 SUMMARY

In this unit, you would recall that we discussed multinational control systems. This was discussed under three sub-units which are controlling the capital budget, building the profit plan, and profit planning controls.

Multinational control systems attempts to show the management control system adopted by large business group to manage the relationship within the group and monitor their work in order to improve the performance of the entire group.

Controlling the capital budget includes budget controls, fixed exchange rates, current exchange rates and the assessment of alternative approaches. Building the profit plan involves income forecasting and development of the profit plan.

6.0 TUTOR MARKED ASSIGNMENT

1. Define a multinational control system.

2. Discuss the following

   a. budget controls

   b. fixed exchange rates

   c. current exchange rates

   d. assessment of alternative approaches

3. Explain the following in building the profit plan

   a. income forecasting

   b. development of the profit plan

4. Discuss the use of variance analysis in profit planning controls

7.0 REFERENCES/FURTHER READING

Choi, F. D. S and Lewis, G. F. (2003),” Multinational Budgeting and Control Systems.” In International Finance and Accounting Handbook, New York: John Wiley & Sons.

Lau, C. M. and Tan, J. J. (1998), “The Impact of Budget Emphasis, Participation, and Task Different on Managerial Performance: A Cross-Cultural Study of the Financial Services Sector.” Management Accounting Research 9, no 2, pp 163 – 183.

MODULE 4: PERFORMANCE EVALUATION AND FOREIGN CURRENCY ISSUES

UNIT 1: PERFORMANCE EVALUATION IN MULTINATIONAL CORPORATIONS

CONTENT

1.0 INTRODUCTION

Performance evaluation is a critical issue in international accounting. The development of the multinational corporation requires an accounting system that records and reports the results of worldwide operations. Headquarters relies on information to evaluate the performance of subsidiaries and managers from all over the world.

This unit begins with a definition of performance evaluation. We then take a look at various financial measures used by multinationals to evaluate their operations.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define performance evaluation.
2. Explain the following
   a. Profitability measures
   b. Sales growth and cost reduction
   c. Budgets as a success indicator

3.0 MAIN CONTENT

3.1 PERFORMANCE EVALUATION DEFINED

Performance evaluation is the periodic review of operations to ensure that the objectives of the enterprise are being accomplished. In other words, it is a report on the success or failure of an operation. A corporation's performance evaluation is part of its financial control system. One reason for performance evaluation is to reward managers for achieving the organization's goals. Corrective actions can also be taken when achievement falls short of the goals. Performance evaluation guides resource allocation decisions within the multinational organization.

SELF ASSESSMENT EXERCISE
Define performance evaluation.

3.2 FINANCIAL MEASURES USED BY MNCs TO EVALUATE DOMESTIC AND FOREIGN SUBSIDIARIES

MNCs use the various measures to evaluate the results of their operations at home and abroad. Let us discuss some of the measures.

1. **Profitability Measures**

   A fundamental measure of operating success is profitability. This can be expressed as gross profit, net income, or return on investment (ROI). Gross profit (or operating margin) is the difference between revenues and the cost of products sold or services provided. Net income is the "bottom line" profit figure of an operation. Expressed as a rate of return, ROI relates profitability to invested capital. It is said that since shareholders are profit oriented, manager should be as well. Profitability measures imply a level of decentralization that does not always exist in multinational operations.

2. **Sales Growth and Cost Reduction**

   The ability to reach customers is vital to company's long-run success. Customer acceptance of a company's products or services translates directly into the sales (or revenue) figure. Sales growth may also indicate increased market share.

   Cost reduction intensified in the 1990s in response to increased competition brought on by the globalization of product and services markets. Most MNCs re-engineered their businesses to improve efficiencies and many spun off peripheral activities in order to focus on their so-called "core competencies". Outsourcing such functions as accounting and information technology were other cost reduction moves. Sales growth and cost reductions should also improve profitability.

3. **Budgets as a Success Indicator**

   Sometime, budgeting has been accepted as a management tool for controlling operations and forecasting future operations of domestic companies. One purpose of the budget is to clearly set out the objectives of the entity. A budget generally provides a forecast and a means of comparing the actual results, of operations to the budget. This comparison produces variances that can be analyzed to evaluate performance and improve the efficiency of future operations.

   When a budget is used for a foreign subsidiary, the budget should be developed be that subsidiary. The experience of the local manager is extremely important, in that, it produces a deep knowledge of the specific business situation. Thus, the subsidiary manager should fully participate in establishing the subsidiary's goals and in developing its budget. A budget developed on this level will help control the operations and make achievement of goals possible. This budget can be used by the local manager on a daily basis.

Budgeting gives local managers the opportunity to set their own performance standards. In international operations, top management is not as familiar with what the standards should be. Headquarters must rely to a greater extent on good local or regional budgets, which help facilitate the strategic planning process.

The subsidiaries' budgets are approved at the parent-company level and often require the endorsement of the president and/or the board of directors. Presumably, headquarters uses the budget to consider the circumstances peculiar to each subsidiary. All of this should ensure a two-way flow of communication between the subsidiary and headquarters, which in turn, will improve the overall budgeting process.

SELF ASSESSMENT EXERCISE

What are the various measures used by MNCs to evaluate the results of their operations at home and abroad?

4.0 CONCLUSION

Multinational corporations need flexible performance evaluation models capable of incorporating factors peculiar to an MNC for the separate evaluation of subsidiary and managers. Because performance evaluation systems used by MNCs have international economic impact, these systems should be under constant examination, and improvements should be made continuously.

5.0 SUMMARY

In this unit, we discussed performance evaluation in multinational corporations. We were able to define performance evaluation and discussed financial measures used by MNCs to evaluate domestic and foreign subsidiaries.

6.0 TUTOR MARKED ASSIGNMENT

1. Define performance evaluation

2. Explain the following financial measures

   a. Profitability measures

   b. Sales growth and cost reduction

   c. Budgets as a success indicator

7.0 REFERENCES/FURTHER READING

Borkowsi, S. C. (1999), "International Management Performance Evaluation: A Five Country Comparison." Journal of International Business Studies 30, no. 3, pp 533 – 555.

Indjejkian, R. I. (1999), "Performance Evaluation and Compensation Research: An Agency Perspective." Accounting Horizons 13, no. 2, pp 147 – 157.

Lau, C. M. and Tan, J. J. (1998), "The Impact of Budget Emphasis, Participation, and Task Different on Managerial Performance: A Cross-Cultural Study of the Financial Services Sector." Management Accounting Research 9, no 2, pp 163 – 183.

MODULE 4: PERFORMANCE EVALUATION AND FOREIGN CURRENCY ISSUES

UNIT 2: ISSUES TO CONSIDER WHEN DEVELOPING MNC EVALUATION SYSTEMS

CONTENT

1.0 INTRODUCTION

In the previous unit, we discussed performance evaluation in multinational corporations. We are taking a step further in this unit to discuss several issues that must be considered when evaluating domestic and foreign operating environments, subsidiaries and managers.

2.0 OBJECTIVES

After studying this unit, you should be to:

1. Discuss separating manager performance from subsidiaries performance.
2. Discuss treating foreign subsidiaries as profit centres
3. Discuss currency choice

3.0 MAIN CONTENT

3.1 SEPARATING MANAGER'S PERFORMANCE FROM SUBSIDIARY'S PERFORMANCE

Many managerial accountants advocate making a distinction between the performance of the subsidiary manager and that of the subsidiary itself. In practices, MNCs report that they do not make a distinction between the evaluation of the manager and the subsidiary. Surveys continue to show that MNCs use the same measures to evaluate the same performance of the manager as that of the foreign subsidiary.

Responsibility reporting as an accounting system traces costs, revenue, assets and liabilities to the individual manager who is responsible for them. It follows that a manager who has the ability to control the results of operations should be evaluated on the basis of the results over which she or he has control. This system has been widely implemented in US domestic operations and has proven to be generally effective as an evaluation tool. However, the very nature of international operations does not lend itself to effectively implementing a responsibility reporting system in MNCs.

MNC headquarters manages from a worldwide perspective and allocates costs and sets transfer prices to optimize companywide profits and to facilitate worldwide cash flows. Therefore, it is naive to evaluate the operating performance of foreign subsidiary managers without first considering all the possible uncontrollable cost that could be allocated to their operations. For these reasons, evaluating a manager's performance should be separate from judging the subsidiary as an investment. The manager's evaluation should involve a degree of subjectivity that considers the uniqueness of the subsidiary, environmental peculiarities, actions of the host government, and specific goals of the manager being evaluated. If managers are delegated responsibility for results that are beyond their control, it may lead to behaviour that is not in line with headquarters' goals.

SELF ASSESSMENT EXERCISE
Should the performance of managers be separated from the performance of the subsidiaries?

3.2 TREATING FOREIGN SUBSIDIARIES AS PROFIT CENTRES

Profit centres located international do not operate in a uniform environment. They operate in environment with different inflation rates and different economic, political, cultural and technological conditions. Top management is not likely to understand all the peculiarities of each environment; therefore, it will have trouble evaluating the manager's performance. For these reasons, the profit centre concept is less useful when applied to foreign subsidiaries than when applied to domestic subsidiaries. Therefore, it is less successful as a performance indicator. Local managers and subsidiaries of MNCs are often evaluated like profit centres. Yet central coordination of the MNC makes it difficult to evaluate the local managers' performance. These managers do not make many of the important decisions affecting their operations. It is also difficult to evaluate how effectively a subsidiary is using its resources. The responsibility reporting concept implies that the manager and the local entity should be evaluated separately. Separating the two; enables each to be judged according to its contribution to global optimization.

SELF ASSESSMENT EXERCISE
Profit centres located international do not operate in a uniform environment. Explain.

3.3 CURRENCY CHOICE

The accounting records and financial statements of a foreign subsidiary are generally maintained in the subsidiary's local currency. Therefore, an issue arises as to which currency should be used to evaluate the performance of the subsidiary and its manager. Two logical candidates are the subsidiary's local currency or the parent's home currency.

It was recommended to use local currency information. This is because, it would results in far more meaningful and valid comparisons of past, present and future operations of a subsidiary. Using the local currency is consistent with isolating and weighing the environmental peculiarities of each operating environment. Such information relates to local conditions and it avoids the distortions that result from fluctuating exchange rates. A local currency perspective also applies to evaluating the foreign manager. Managers should be evaluated as meeting primary goals in the local currency (e.g annual profits and sales forecasts, meeting projected production levels, managing the effects of inflation and managing employees).

SELF ASSESSMENT EXERCISE

Why was it recommended to use local currency information?

4.0 CONCLUSION

If the parent's home currency is used for performance evaluation, then foreign currency translation methods must be employed. Studies have shown that most US MNCs use the same method to translate for internal reporting purposes (managerial accounting) that they use for external reporting purposes.

5.0 SUMMARY

In this unit, we discussed those issues to consider when developing MNC evaluation systems. This was discussed under various sub-units such as separating manager's performance from subsidiary's performance, treating foreign subsidiaries as profit centres and currency choice.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss separating manager's performance from subsidiary's performance.

2. Discuss treating foreign subsidiaries as a profit centre.

3. Discuss currency choice

7.0 REFERENCES/FURTHER READING

Borkowsi, S. C. (1999), "International Management Performance Evaluation: A Five Country Comparison." Journal of International Business Studies 30, no. 3, pp 533 – 555.

Indjejkian, R. I. (1999), "Performance Evaluation and Compensation Research: An Agency Perspective." Accounting Horizons 13, no. 2, pp 147 – 157.

Lau, C. M. and Tan, J. J. (1998), "The Impact of Budget Emphasis, Participation, and Task Different on Managerial Performance: A Cross-Cultural Study of the Financial Services Sector." Management Accounting Research 9, no 2, pp 163 – 183.

MODULE 4: PERFORMANCE EVALUATION AND FOREIGN CURRENCY ISSUES

UNIT 3: FOREIGN CURRENCY TRANSLATION

CONTENT

1.0 INTRODUCTION

The foreign subsidiaries of multinational corporations normally keep their accounting records and prepare their financial statements in the currency of the country in which they are located. They do this because it would be too inconvenient to transact business in anything other than the local currency and too impractical to record these transactions in accounting records using another country's currency. As a result, the individual financial statements of a multinational's foreign subsidiaries are expressed in many different currencies. Yet in order for worldwide consolidated financial statement to be prepared, the subsidiaries' financial statements must all be expressed in a single currency. Therefore, whenever multinational corporations prepare their consolidated financial statements, the financial statements from individual foreign subsidiaries must be translated from the currency of the foreign country into the currency of the country where the multinational is headquartered. Foreign currency translation is accomplished using exchange rates.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. List and explain the reasons for exchange rates changes.
2. State the steps taken in the translation of financial statements as contained in Financial Accounting Standard 52.
3. Familiarize yourself with the impact of foreign exchange rates changes.

3.0 MAIN CONTENT

3.1 EXCHANGE RATES

The major currencies of the world are traded in many places and in many ways. An exchange rate is the price of one currency relative to another. That is, how much of one currency it takes to buy so much of another currency. Exchange rates are not stable over time; they fluctuate just like the price of nearly everything else does. Exchange rates change for the following reasons:

1. Trade balance of payments surpluses or deficits. When a country exports more than it imports, it is said to run a trade balance of payments surplus. Surpluses cause the nation's currency to appreciate in value. The opposite condition-trade deficits, - causes a currency to command less of other nations' currencies.

2. Relative rates of inflation- currencies of countries with higher rates of inflation depreciate relative to the currencies of countries with lower levels of inflation. Generally speaking, inflation means that one is able to buy less and less of everything (including another country's currency) for a fixed amount of one's own currency.

3. Relative interest rates- whenever one nation has higher interest rates relative to other nations, its currency appreciates in value.

4. Political factors and government intervention. For international transactions, the currencies of countries considered politically stable tend to be favoured over the currencies of unstable countries. Governments also buy and sell currencies when they want to change exchange rates.

SELF ASSESSMENT EXERCISE
State the reasons for the changing of exchange rates.

3.2 Translation

The entire task of foreign currency translation can be understood as determining the correct exchange rate to be used in converting each financial statement like item from the foreign currency to the headquarters country's currency. The translation adjustment is an inherent result of this process, in which balance sheet and income statement items are translated at different rates. Financial Accounting Standards (FAS 52) establishes these steps:

1. Determine the functional currency. The functional currency is defined as the currency of the primary economic environment in which the entity operates. Normally, that is the currency in which the majority of the subsidiary's business activities are transacted. The functional currency is not necessarily the home currency or the currency in which the subsidiary keeps its books.

2. Determine whether the functional currency of the subsidiary is also its home currency.

3. If the functional currency is the home currency, the current method is used. The current method translates all assets and liabilities at the current spot rate at the date of translation. Equity items, other than retained earnings are translated at the spot rates in effect on each

related transaction date (specific identification). Retained earnings are translated at the weighted- average rate for the relevant year, with the exception of any components that are identifiable with specific dates, in which case the spot rates for those dates are used. Income statement items are translated at the average rate for the period, except where specific identification is practicable.

4. If the functional currency of the subsidiary is not its home currency, the temporal (historical) method is used. Under this method, nonmonetary balance sheet accounts and related income statement accounts are re-measured using historical exchange rates.

5. Under FAS 52, the temporal method is also used when the subsidiary operates in a highly inflationary environment. Companies reporting under International Financial Reporting Standards (IFRS) treat this differently by re-measuring the financial statements at the current balance sheet rate in order to present current purchasing power. GAAP, on the other hand, does not generally permit inflation- adjusted financial statements. Instead, it requires the use of a more stable currency as the functional currency.

SELF ASSESSMENT EXERCISE
Outline the steps in translation of currency.

3.3 DETERMINING EXCHANGE RATE(S)

A question may arise as to which exchange rate should be used to translate the financial statements of a foreign subsidiary given that exchange rate changes. One possibility is the exchange rate at the balance sheet date. Accountants often refer to this as the current or year-end exchange rate. However, translating all financial statement items at the rate existing at the balance sheet date is incompatible with historical cost.

Suppose a US parent company invest $30,000 in a foreign subsidiary and the subsidiary converts the money to its local currency when the exchange rate is 1LC (local currency) = $1.25. The foreign subsidiary takes its LC24,000 (i.e $30,000/1.25) and buys land. On a historical cost basis, the land has a value of LC24,000 or $30,000. If by year end the exchange rate changes to 1LC=$1.50 and is used to translate the LC24,000 piece of land, it will appear on the consolidated US dollar financial statements at $36,000 (i.e LC24,000 X $1.50). The piece of land appears to have magically increased in value.

The $1.25 equal to 1LC which was the exchange rate when the transaction was first recorded is what is referred to, by the accountants as the historical exchange rate. This way, the land would always appear on the consolidated balance sheet at $30,000.

Unfortunately, another problem arises when historical exchange rates are used. Since the various assets are acquired at different times, different exchange rates have to be used to translate them. When this happens, the translated balance sheet no longer balances. What to do with the difference between debits and credits is a highly controversial subject among accounts. The amount of the imbalance arises mechanically as a result of the translation process and does not fit the definition of asset, liability or owners' equity. Yet, it has to go somewhere to preserve the accounting equation.

The following example illustrates the point. Assume that on January 1, US multinational forms a foreign subsidiary and converts $100,000 into the subsidiary's local currency (let say naira) at a time when the exchange rate is N1=$1.25. The initial investment, therefore, is N80,000. The subsidiary opening balance sheet would be

Subsidiary

Balance sheet as at 1st January, 2011

Cash	N80,000 X (N1=$1.25) =		$100,000
Financed by:			
Owners' equity	N80,000 X (N1=$1.25) =		$100,000

Now assume that on February 1, when the exchange rate is N1= $1.30, foreign subsidiary buys N40,000 worth of inventory. On February 28, when the exchange rate is N1=$1.40, subsidiary buys a fixed asset for N40,000. The March 1 balance sheet will look like this.

Subsidiary

Balance sheet as at 1st March, 2011

Inventory	N40,000	X (N1=$1.30) =	$52,000
Fixed asset	N40,000	X (N1=$1.40) =	$56,000
	N80,000		$108,000
Financed by:			
Owners' equity	N80,000	X (N1=$1.25) =	$100,000
	N80,000		$100,000

While the balance sheet before translation (in local currency) balances, it does not balance after translation into US dollars. In the translated balance sheet, debits exceed credit by $8,000. What to do with the nonexistent credit is a good question, and accountants disagree on the answer.

SELF ASSESSMENT EXERCISE

Translating all financial statement items at the rate existing at the balance sheet date is incompatible with _________.

4.0 CONCLUSION

Preserving the historical cost basis of accounting by translating foreign financial statements at different historical exchange rates introduces a dangling debit or credit whose nature is difficult to define. That problem can be solved by translating financial statements using a single exchange rate, but the procedure is inconsistent with the historical cost basis of accounting. Either choice involves some undesirable side effects.

5.0 SUMMARY

In this unit, we discussed foreign currency translation. Basically, we defined exchange rate and state the reasons why exchange rates changes. We also looked at the steps taken in carrying out translation as contained in financial accounting standards 52. And finally, we tried discussing which exchange rate should be used to translate the financial statements of a foreign subsidiary.

6.0 TUTOR MARKED ASSIGNMENT

1. List and explain the reasons for exchange rates changes.

2. State the steps taken in the translation of financial statements as contained in FAS 52.

7.0 REFERENCES/FURTHER READING

Benjamin, J. J., Grossman, S. And Wiggins, C. (1996), "The Impact of Foreign Currency Translation on Reporting during the Phase-in of SFAS No. 52". Journal of Accounting, Auditing, and Finance 1, no. 3, pp 174 – 184.

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MODULE 4: PERFORMANCE EVALUATION AND FOREIGN CURRENCY ISSUES

UNIT 4: TRANSLATION METHODS

CONTENT

1.0 INTRODUCTION

This unit is an extension of the previous unit on foreign currency translation. Having discussed the relevant issues as contained in unit 13, it becomes imperative here that we should step further in discussing the translation method and modified current rate method.

2.0 OBJECTIVES

After studying this unit, you should be able to

1. Discuss what it means to translate a financial statement item at the historical exchange rate.
2. Discuss what it means to translate items in the financial statement at the current exchange rate.

3.0 MAIN CONTENT

3.1 TEMPORAL METHOD

Before statement 52 of FAS on foreign currency translation issued by the Financial Accounting Standards Board (FASB) IN 1981, US multinational corporations translated the financial statements of their foreign subsidiaries under the terms of statement 8 issued by the FASB in 1975. Statement 8 required the use of what is called temporal method of foreign currency translation. A mixture of different historical exchange rates and the current exchange rate are used to translate the items on the subsidiary's balance sheet and income statement. The resulting "dangling debit or credit" is treated as a loss or gain on the consolidated income statement. During the years that statement 8 was in effect, exchange rates were highly volatile, and because the translation imbalance was required to increase or decrease reported income or loss, corporations experienced more volatility in their reported earnings than management desired. A volatile earnings pattern normally indicates riskiness, yet management alleged that translation gains and losses were on paper only- that they had little or no direct effect on actual cash flows. A large number of accountants cried 'foul' and it is fair to say that statement 8 was probably the most unpopular statement ever issued by the FASB. For this reason statement 8 was replaced by statement 52.

Illustration of Temporal Method

Assume that the following trial balance, expressed in local currency (Naira), is received from a foreign subsidiary. The year-end exchange rate is N1=$1.40 and the average exchange rate for the year is N1=$1.20. Under the temporal method, the trial balance is translated as follows:

1. Inventory and cost of goods sold, at the exchange rate when the inventory was purchased. Assume this is N1=$1.25.
2. Fixed assets and depreciation expense, at the exchange rate when the fixed assets were purchased. Assume this is N1=$0.90.
3. Other balance sheet items, the year-end exchange rate (i.e N1=$1.40).
4. Revenues and expenses that are incurred evenly throughout the year (sales and other expenses) at the average exchange rate (N1=$1.20).
5. Beginning owners' equity in dollars equals last year's ending owners' equity (translated) in dollars. Assume this is $81,000.
6. A "translation" gain or loss is created to balance the dollar dominated trial balance.

Thus, the temporal method translation would be

	Naira		Exchange rate	Dollars	
	Debit	Credit		Debit	Credit
Cash	15,000		(N1=$1.40)	21,000	
Inventory	70,000		(N1=$1.25)	87,500	
Fixed assets	35,000		(N1=$0.90)	31,500	
Payables		30,000	(N1=$1.40)		42,000
Owners' equity (beginning)		70,000			81,000
Sales		200,000	(N1=$1.20)		240,000
Cost of goods sold	120,000		(N1=$1.25)	150,000	
Depreciation exp.	5,000		(N1=$0.90)	4,500	

Other expenses	55,000		(N1=$1.20)	66,000	
Translation loss				2,500	
	300,000	**300,000**		**363,000**	**363,000**

SELF ASSESSMENT EXERCISE

Solve the question in the illustration without looking at the solution and compare your result to the solution in the illustration.

3.2 MODIFIED CURRENT RATE METHOD

Under the provisions of statement 52, a foreign subsidiary is classified as either

1. Self-sustaining and autonomous or
2. Integral to the activities of the parent company.

A self-sustaining, autonomous subsidiary is one that operates relatively independently from the parent company. Revenues and expenses respond mostly to local conditions, few of the subsidiary's cash flows impact the parent company cash flows, and there are few intra company transactions with the parent. The local (foreign) currency is said to be its 'functional' currency. The balance sheet for a self-sustaining subsidiary is translated at the year-end exchange rate and the income statement at the average for the year exchange rate. There is no effect on reported consolidated earnings from translating the financial statements of autonomous foreign subsidiaries. This is called modified current rate method which preserves the balance sheet and income statement financial ratios in the US dollars as in the local currency.

Illustration of Modified Current Rate Method

	Naira		Exchange rate	Dollars	
	Debit	Credit		Debit	Credit
Cash	15,000		(N1=$1.40)	21,000	
Inventory	70,000		(N1=$1.40)	98,000	
Fixed assets	35,000		(N1=$1.40)	49,000	
Payables		30,000	(N1=$1.40)		42,000
Owners' equity		70,000	to balance		102,000
Sales		200,000	(N1=$1.20)		240,000
Cost of goods sold	120,000		(N1=$1.20)	144,000	
Depreciation exp.	5,000		(N1=N1.20)	6,000	
Other expenses	55,000		(N1=$1.20)	66,000	

300,000	**300,000**	**384,000**	**384,000**

SELF ASSESSMENT EXERCISE
What is a self-sustaining or autonomous subsidiary?

4.0 CONCLUSION

Consolidated financial statements are intended to present an overall look at a company's operations and financial position. Unfortunately, for multinational corporations existing accounting tools are not always up on the task. Measuring accounting earnings is an imperfect process anyway, but when fluctuating foreign exchange rates are introduced into that process, it gets even more jumbled.

5.0 SUMMARY

In this unit, we discussed translation methods which are temporal method and modified current rate method. The temporal method was based on statement 8 issued by the Financial Accounting Standards Board and the modified current rate method is based on statement 52 of FASB.

6.0 TUTOR MARKED ASSIGNMENT

1. What does it mean to translate a financial statement item at the historical exchange rate?

2. What does it mean to translate an item at the current exchange rate?

7.0 REFERENCES/FURTHER READING

Benjamin, J. J., Grossman, S. And Wiggins, C. (1996), "The Impact of Foreign Currency Translation on Reporting during the Phase-in of SFAS No. 52". Journal of Accounting, Auditing, and Finance 1, no. 3, pp 174 – 184.

Choi, F. D. S., Frost, C. A. And Meek, G. K. (1999), "Foreign Currency Translation." In International Accounting , Upper Saddle River: Prentice Hall.

Harris, T. S. (1997), "Foreign Currency Transactions and Translation." In International and Finance Handbook, New York: John Wiley & Sons.

MODULE 5: INTERNATIONAL TAXATION AND TRANSFER PRICING

UNIT 1: INTERNATIONAL TAXATION

CONTENT

1.0 INTRODUCTION

Tax systems are used worldwide to affect economic policy, social issues, and the political scene; they are as varied as the nations developing them. International taxation is extremely complex and constantly changing. As tax treaties, agreements, laws and regulations change, the multinational tax network must be reviewed and reworked to maintain relative worldwide advantages.

Globalization makes it hard to decide where a company should pay tax, regardless of where its headquarters are or where it chooses to incorporate. Multinational corporations design their products in one country, manufacture them in another, and then sell them all over the world.

Tax planning is perfectly legal and as long as there are disparities in the tax rates, there is room for this type of planning. Multinational companies say the job of preparing their taxes is credibly complex and expensive. It becomes imperative to discuss international taxation and its pervasive influence on MNC operations. This unit discusses some of the available strategies that MNCs use to minimize their worldwide tax liability and an overview of taxation.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Discuss the methods of taxation.
2. Discuss classical versus integration system of taxation
3. Explain who is subject to tax.
4. Explain the determination of tax base and rates.
5. Explain tax credit, tax treaties, tax havens, deferral principle and tax exemption.
6. State the procedures in minimizing and avoidance of tax in a tax planning information system.

3.0 MAIN CONTENT

3.1 AN OVERVIEW OF TAXATION

1. Methods of taxation- with the possible exception of cost of goods sold, taxation is the largest expense of any business. Taxes can take many forms, and a variety of methods have been used to categorize taxes. There are taxes that are clearly recognizable and can be found on a financial statement, such as income taxes. In addition, there are indirect taxes, such as consumption taxes, whether they be a state or local sales tax, which is common in the United States or a value-added tax, which is more common outside the United States; property or capital taxes; excise taxes; estate and gift taxes, employment taxes, and so-called user fees, a term that may be more politically acceptable than the term tax. Although international business tends to focus on income taxes, other taxes, especially consumption type taxes, may have an important impact on a business activity. Although estate and gift taxes impact on individuals rather than on business entities, because they can impact on employees who are transferred into a foreign country, they impact on the employer. Consumption taxes affect the cost of assets purchased by a business entity, and, when they take the form of a transfer tax, they often dictate the means of buying and selling businesses. Despite the importance that non-income taxes can have on a business enterprise, businesses tend to focus more on income taxes, since these taxes can most easily be affected by tax planning.

2. Classical versus integration- a classical system of taxation means that there is a tax at the corporate level, with a second tax at the shareholder level, when the corporate profits are either distributed as a dividend to the shareholders or the shareholders sell their investment in the underlying corporation. The United States has this kind of taxation system.

On the other hand, an integration system of taxation means that the corporate tax and the shareholder taxes are integrated in such a Fashion so that only one tax is levied on the profits. In most cases, there is a lack of full integration but only a partial integration. This integration can take several forms. In some countries, such as Germany, retained profits are taxed at a higher rate than distributed profits. In other countries, such as the United Kingdom, shareholders receive a credit for some of the underlying corporate taxes. Depending on the form that integration takes, it has a potential of favouring local investors and discriminating against foreign investors.

3. Who is subject to tax? Countries typically exercise jurisdiction either over the taxpayer or over the income or property. The United States claims both jurisdictions. Thus, it taxes American corporations and citizens on their worldwide income- income earned from sources within the United States, as well as income earned from foreign sources. In addition, it takes foreign corporations and foreign residents on income earned from sources within the United States or property located within the United States. Some countries only exercise taxing jurisdiction on income from sources within a country and exempt or spare from taxation income earned outside their borders. Although, many countries exercise only this “source jurisdiction”, the methods of determining source are not uniform. In addition, those countries that claim taxpayer jurisdiction do not apply this method in a uniform way. For example, most countries tax residents but not citizens who are not residents, whereas the United States taxes it U.S. citizens working abroad even if they are not resident in the United States.

4. Determination of tax base- in determining the magnitude of a country’s tax, one tends to focus on tax rates. It is, however, at least equally important to focus on how the tax base is determined. One only has to think back to the 1986 Tax Reform Act in the United States, in which tax rates were lowered; however, the tax liability of most taxpayers increased, because the tax base was expanded by means of eliminating deductions for certain expenditures. Consequently, in analyzing the tax impact on an anticipated business activity, it is necessary to determine both the tax base and the tax rate.

5. Rates- there has been a worldwide tendency, starting in the United States and then the rest of the world, for income tax rates to decline, with a corresponding base broadening, in order to maintain the level of taxes raised by the government.

SELF ASSESSMENT EXERCISE
Explain what you understand by determination of tax base.

3.2 PHILOSOPHY OF TAXATION

A country may follow the territorial principle that income earned outside its domestic boundaries is not taxed. Other nations follow the worldwide principle that they have the right to tax income earned outside their boundaries when earned by an entity based in the country. The worldwide principle results in double taxation because the income is taxed where earned and then again to the parent company.

However, double taxation is mitigated by tax credits, tax treaties, tax havens, “deferral principle”, and tax exemption. A tax credit allows an entity to reduce the taxes paid to the domestic government by the amount of taxes paid to the foreign government. A credit is a direct reduction of the tax liability and reduces double taxation to a certain extent. A tax treaty between nations establishes what items of income will or will not be taxed by the authorities of the country where the income is earned. A tax haven is a country with an exceptionally low, or even no income tax. It generally offers a company the right to earn or transfer income within its borders and pay little or no tax. Tax havens are normally used by MNCs to shift income from a country with a high tax rate to the tax haven.

The Isle of Man, a British seaside resort, is just such a tax haven. It is a self-ruling dependency with enough autonomy to set its own tax rates on corporations and individuals, both currently at more than 20 percent. Over the past 20 years, financial services businesses have located their offices on, and moved money to, this island. The Isle of Man economy is growing twice as fast as that of Great Britain. The deferral principle works so that parent companies are not taxed on foreign source income until they actually receive a dividend. A tax exemption allows certain corporations to pay no tax on certain income.

SELF ASSESSMENT EXERCISE
What is tax credit?

3.3 MNC TAX AVOIDANCE

Tax avoidance is the legal reduction of one’s tax liability and is accomplished by tax planning. Tax avoidance enters into most managerial decisions and, therefore, plays a role in the planning process, the management control system, and performance evaluation. A tax planning information system that attempts to accomplish worldwide tax minimization and tax avoidance should incorporate the following procedures:

1. Stating the objectives of tax planning in MNC operations.
2. Delegating responsibilities for tax planning to both headquarters and subsidiaries.
3. Determining what operations are affected by tax considerations and how they are affected.
4. Communicating necessary information to the tax planners and decision makers, and
5. Evaluating the impact tax considerations have on an MNC strategic plan and management control system.

SELF ASSESSMENT EXERCISE
What is tax avoidance?

4.0 CONCLUSION

In prior units, we discussed diversity in financial accounting practices throughout the world and efforts to harmonize these practices. Now we see a tremendous amount of global diversity in tax philosophy, policies, incentives and rates. The international harmonization of taxation would certainly simplify business decision making. The European Union is attempting to accomplish this as the 15 member countries become a single market. International tax reform is a topic on many multinational companies' board of directors' agendas.

5.0 SUMMARY

In this unit, you would recall that we discussed international taxation. This topic was discussed under the following sub-units which are; an overview of taxation; philosophy of taxation and MNC tax avoidance.

An overview of taxation was discussed considering methods of taxation, classical versus integration, who is subject to tax?, determination of tax base and rates. The philosophy of taxation was discussed considering tax credits, tax treaties, tax havens, and deferral principle and tax exemption.

And finally, the procedure for tax avoidance minimization was discussed under MNC tax avoidance.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss the methods of taxation

2. Discuss classical versus integration system of taxation.

3. Explain who is subject to tax.

4. Explain the determination of tax base and rates.

5. Briefly explain the following

   a. tax credit

   b. tax treaties

   c. tax havens

   d. deferral principle

e. tax exemption

6. State the procedures in minimizing and avoiding tax in a tax planning information system.

7.0 REFERENCES/FURTHER READING

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MODULE 5: INTERNATIONAL TAXATION AND TRANSFER PRICING

UNIT 2: UNITED STATES TAXATION OF A FOREIGN CORPORATION

CONTENT

1.0 INTRODUCTION

From the previous unit, we discussed international taxation. The term international taxation is a misnomer in that there is not an independent body of law that applies to international business transactions. Instead, the United States and other countries apply general tax rules to domestic companies operating abroad and foreign businesses investing locally, supplemented by special provisions. The United States has the most complex tax system in the world, and especially complex are the provisions that deal with international business activities. This unit would discuss these U.S. tax rules.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain U.S. taxation on investment income and business income.
2. Discuss U.S. Trade or Business
3. Explain Branch Profits Tax

3.0 MAIN CONTENT

3.1 INVESTMENT AND BUSINESS INCOME

Foreign corporations are subject to U.S. taxation on certain investment income from U.S. sources and on business income that is “effectively connected” with a U.S. trade or business.

INVESTMENT INCOME- U.S. source investment income is subject to a 30% gross receipts tax it is not effectively connected with the conduct of a U.S. trade or business. Income subject to this 30% flat-rate tax includes:

1. Fixed or determinable annual or periodic income.
2. Timber, coal or iron ore royalties.

3. Original issue discount.
4. Gains from the sale or exchange of intangible property such as patents and copyrights, to the extent that the gains are contingent on the productivity, use, or disposition of the property sold and thus, economically similar to royalties.

Certain income is exempt from this 30% gross receipts tax in order to encourage foreign investment in the United States. The exempt income includes interest on bank deposits if the interest is not attributable to a U.S. trade or business. Another similar exemption is interest that qualifies as "portfolio interest". This is certain targeted bonds that are sold only to foreign investors and that cannot be owned by U.S. corporations, citizens, or residents. In addition, the interest cannot be received from a corporation or a partnership in which the recipient has a 10% or greater interest and cannot be received by a bank. This portfolio interest exception is designed to cover Eurodollar bonds sold to the public outside the United States and eliminates the need for utilization of expensive structures that typically have included utilizing finance companies organized in the Netherlands or Netherlands Antilles. At present, if a foreign corporation has a U.S. subsidiary and it sells the shares of the U.S. subsidiary, the gain is not subject to U.S. taxation unless the subsidiary constitutes a "U.S. real property interest".

In many cases, this 30% gross receipts tax is reduced to a lower rate or completely exempted by an income tax treaty between the United States and the country of residence of the foreign investor.

BUSINESS INCOME-Business income that is effectively connected with the conduct of a U.S. trade or business is taxed at the normal U.S. rates. The income attributable to U.S. trade or business is income that is effectively connected with the conduct of a U.S. trade or business and sometimes referred to as "ECI (effectively connected income)". Deductions are allowed to the extent they relate to the ECI. Complex regulations are used to determine when expenses of a foreign corporation are attributable to ECI.

SELF ASSESSMENT EXERCISE
How is investment income taxed?

3.2 U.S. TRADE OR BUSINESS

In order for a foreign corporation to be engaged in a U.S. trade or business, there must be a significant amount of business activity in the United States. The term trade or business is not defined in the tax law but is based upon specific facts and circumstances of the taxpayer. Foreign investors, other than dealers, can trade in stocks, securities, and commodities in the United States without being engaged in a trade or business in the United States.

A foreign corporation that is engaged in trade or business within the United States is taxed at the regular corporate rate on income that is "effectively connected" with the conduct of that trade or business. This effectively connected concept applies to four types of income:

1. Gain or loss from the sale or exchange of capital assets.
2. Fixed or determinable annual or periodic income.
3. Gain or loss in the disposition of U.S. real property interest.
4. All other income, gain or loss.

All income from U.S. real property interest is automatically considered ECI. U.S. source capital gains and fixed or determinable income are only ECI if they are attributable to a U.S. trade or business. Fixed or determinable annual periodic income refers to interests, dividends, rents, wages, and similar types of income. For nonfinancial institutions, the primary determination of whether such income is ECI, is based upon the "asset use" test. Under this test, if the test is held by the U.S. trade or business, or has some type of direct relationship to the U.S. trade or business, then the income generated by that asset is ECI. The "business activities" test is used by financial institutions. If the business activities that generated the income are performed by personnel associated with a U.S. office, then the income is ECI.

SELF ASSESSMENT EXERCISE
Outline the income to which the effectively connected concept applies.

3.3 BRANCH PROFITS TAX

As indicated in the previous unit, the United States has the classical system of taxation, that is, income taxed both at the corporate level and the shareholder level. Thus, income earned by a U.S. corporation is subject to U.S. tax and, when the income is paid out as a dividend to a foreign shareholder, the dividend will constitute U.S. source fixed or determinable annual or periodic income and will thus be subject to 30% or lower treaty rate of tax.

A branch profits tax is designed to subject to U.S. branch of a foreign corporation to the same level of tax that would be paid if the business activities were performed in subsidiary form rather than as a branch of a foreign corporation. This is done by imposing a 30% or lower treaty rate of tax on a foreign corporation's "dividend equivalent amount". This amount is the foreign corporation's effectively connected earnings and profits that are not reinvested in the United States but are instead repatriated to the foreign head office. This means that if a foreign corporation had 100 of effectively connected income before corporate tax, it would pay a corporate tax of 35 percent and 19.5 percent [30% of (100 – 35)] for a total tax burden of 54.5 percent. Just as many income tax treaties reduce the rate of tax on dividend, many treaties either reduce the branch profits tax or prevent the United States from imposing the branch profit tax. These treaties are overridden by internal law if the foreign corporation is not a "qualified residents of that country. Thus, for example, if residents of a non-treaty country owned all the stock of a Dutch corporation, which in turn had a branch in the United States, the Dutch Corporation would not be considered a "qualified resident", and thus the United States could impose the branch profits tax. In addition to the tax on the dividend equivalent amount, there is a branch level interest tax that operates in such a fashion as to treat interest paid by a U.S. branch of a foreign corporation as if it were paid by a U.S. subsidiary of the foreign corporation. Consequently, such interest paid to foreign investors would be subject to the 30% U.S. tax unless reduced or eliminated by an income tax treaty.

4.0 CONCLUSION

The United States has entered into many income tax treaties. The express purpose of these treaties is to eliminate international double taxation and render mutual assistance in tax enforcement.

The U.S. foreign tax credit goes a long way towards eliminating international double taxation of U.S. taxpayers. Many countries avoid international double taxation by not taxing their taxpayers on foreign source income. To a large extent, the income tax treaties determine the amount of tax to be paid to the country where the income is produced and the amount to be paid to the taxpayer's country of residence. It does this by providing for reduced rates of tax or complete exemptions from tax for certain specified items of income.

5.0 SUMMARY

In this unit, you would recall that we discussed the United States taxation of a foreign corporation. This was discussed considering investment and business income, United States Trade or business, and branch profits tax.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain U.S. taxation on investment income and business income.

2. Discuss U.S trade or business.

3. Explain branch profits tax.

7.0 REFERENCES/FURTHER READING

Bodner, P. (1997), "International Taxation." In International Accounting and Finance Handbook. 2nd ed. F.D.S. Choi, New York: John Wiley & Sons, pp. 39: 1 – 21.

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MODULE 5: INTERNATIONAL TAXATION AND TRANSFER PRICING

UNIT 3: MULTINATIONAL TRANSFER PRICING

CONTENT

1.0 INTRODUCTION

The need for determining a transfer price arises when goods or services are exchanged between organizational units of the same company (e.g., charges for administrative and managerial services, royalties for intangible rights, transfers of finished goods for resale and charges for technical services). A transfer price is a substitute for a market price. It is used when one subsidiary of a corporation sells to another. The transfer pricing system places a monetary value on intra company exchange that occurs between operating units. This price is recorded by the seller as revenue and by the buyer as cost. For example, subsidiary A sells 1000 units of product X to subsidiary B for N80 per unit. The N80 selling price is the transfer price. It is generally agreed that the transfer pricing system for a domestic corporation should accomplish certain objectives including:

1. The communication of information resulting in desirable decision making by managers.
2. Providing a report of divisional profits that reasonably measures the economic performance of the division and
3. Enhancing goal congruence.

In this unit, we shall be discussing some of the objectives of international transfer pricing.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. State the objectives of international transfer pricing.
2. Discuss global income tax minimization.
3. Describe the use of transfer prices to reduce tariffs.
4. Describe how transfer prices could be used to mitigate economic restriction.

3.0 MAIN CONTENT

3.1 AN OVERVIEW OF THE OBJECTIVES OF INTERNATIONAL TRANSFER PRICING

Developing an MNC transfer pricing system is far more complex than developing a domestic system. As with the domestic corporation, an MNC pricing system should result in managers making desirable decisions that enhance goal congruence. Providing a reasonable measure of a subsidiary's economic performance is often an irrelevant transfer pricing objective when dealing with an MNC. An MNC pricing system must attempt to meet the objectives of the strategic plan, the management control system, and the system of performance evaluation. The international transfer pricing system must also attempt to accomplished objectives that are irrelevant in a purely domestic operation.

Based on the study of 82 U.S. based multinationals, it was observed that the following are the top ranked objectives of transfer pricing.

1. The management of the overall tax burden.
2. Maintaining a competitive market position.
3. Performance evaluation.
4. Motivation of managers.
5. Goal congruence between the managers and the firm.
6. Managing of tariffs and
7. Compliance with the tax law.

It was also observed that tax minimization is not as high a priority outside the United States as it is to managers operating within the United States.

SELF ASSESSMENT EXERCISE
Outline the objectives of transfer pricing.

3.2 GLOBAL INCOME TAX MINIMIZATION

The transfer pricing system can be used to shift taxable profits from a country with a high tax rate to a country with a lower tax rate; the result is that after taxes, the MNC retains more profits. For example, subsidiary A operates in Japan, where the tax rate is 50 percent. Subsidiary B operates in Nigeria with a tax rate of 30%. A sells goods to B at an inflated transfer price of $10 per unit. The current market price is $7 per unit. A shows a higher profit and is taxed at 50%. B shows a higher cost of goods sold and a lower profit on future sales taxed at 30%. These subsidiaries are not practicing global tax minimization. However, this behaviour would not be unusual for a Japanese company. Japanese companies prefer to shift profits to Japan, even though the Japanese corporate tax rate is higher. There are political reasons to shift profits to Japan in order to please the government authorities and to gain cooperation of the local suppliers.

Unless the performance evaluation system is compatible with the transfer pricing system, undesirable decision making can result at the subsidiary manager level. If each subsidiary is evaluated as an independent profit centre, the transfer pricing policies must be considered when evaluating the manager's performance, or else conflict between subsidiary and MNC goals may result.

SELF ASSESSMENT EXERCISE

How does Transfer pricing system be used to shift taxable profit from one country with high tax rate to a country with lower tax rate?

3.3 MINIMIZATION OF GLOBAL IMPORT DUTIES

Transfer prices can reduce tariffs. Import duties are normally applied to intra company transfers as well as to sales to unaffiliated buyers. If the goods are transferred in at low prices, the resulting tariffs will be lower. This same pricing strategy may be used when a country places a ceiling on the value of goods that may be imported. By valuing at low transfer prices, a subsidiary may be able to import a larger quantity of goods and services. If a country had a low tariff on imports, a higher transfer price could be charged. Tariffs interact with income taxes. Low import duties are often associated with a country with high income tax rates. The opposite may also be found- high import duties with low income tax rates. The MNC must deal with the customs officials and income tax administrators of the importing country and with the income tax administrators of the exporting country. A higher import tariff would result in a lower remaining profit for determining income taxes. The MNC has to evaluate the benefits of a lower (higher) income tax in the importing country against a higher (lower) import tariff as well as the potentially higher (lower) income tax paid by the MNC in the exporting country.

3.4 AVOIDANCE OF FINANCIAL RESTRICTIONS

When a foreign government places economic restrictions on MNC operations, transfer prices may mitigate the impact of these national controls. Suppose a country restricts the amount of cash that may leave its boundaries in the form of dividend payments. Setting a high transfer price on goods imported into the country may facilitate the desired movement of cash because the importing subsidiary must remit payment. However, cash transfers are not easily accomplished in a country that watches import and export prices closely.

Some countries allow a tax credit or subsidy based on the value of goods exported. In this case, a high transfer price on exported products is followed by a larger tax credit or higher subsidy. A tax credit of this nature reduces the corresponding tax liability to the host country dollar for dollar and more than offsets the higher taxable income. A subsidy is generally a payment from the government to the subsidiary.

Restrictions may be placed on an MNC by disallowing a foreign subsidiary to deduct certain expenses provided by the parent company against taxable income. Common examples include research and development expenses, general and administrative expense, and royalty fees. By inflating the transfer price of imports to the subsidiary, such expenses may be recovered.

If an MNC desires to show low (high) profitability, high (low) transfer prices on imports to subsidiaries may be used. An MNC may want to appear less profitable to discourage potential competitors from entering the market. Higher profits may cause the subsidiary’s employees to demand higher wages or even to request some type of profit-sharing plan.

Lower transfer prices on imports should improve the subsidiary’s financial position. This may be desirable when the MNC wants to finance the foreign subsidiary with funds from a local lender rather than committing its own capital. In this instance, the lender would probably require that the subsidiary have a positive financial condition. Lower transfer prices may also allow the subsidiary to enjoy a competitive edge during its initial stages of growth.

SELF ASSESSMENT EXERCISE
Describe how transfer prices could be used to mitigate economic restriction.

4.0 CONCLUSION

Accomplishing the objectives of transfer pricing is difficult without considering the applicable tax laws. These objectives are so important at times that they take precedence over the objectives of management control and performance evaluation. However, all are components of the strategic planning system and work toward the optimal achievement of a multinational corporation's comprehensive international plan.

5.0 SUMMARY

In this unit, you would recall that we discussed transfer pricing. This was discussed considering some of the objectives of international transfer pricing.

6.0 TUTOR MARKED ASSIGNMENT

1. State six objectives of international transfer pricing.

2. Discuss global income tax minimization.

3. Describe the use of transfer prices to reduce tariffs.

7.0 REFERENCES/FURTHER READINGS

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