ACT 416

ACCOUNTING FOR MULTINATIONAL CORPORATIONS

Learning Objectives

At the end of the lesson, the student should be able to:

1. Explain the concept of Multinational corporations

2. Discuss the characteristics of MNCs

3. Highlight the Pros and cons of MNCS

4. Discuss the relationship between MNCs and consolidated financial statements.

5. Discuss the accounting issues of multinational corporations

Main Content

MEANING OF MULTINATIONAL CORPORATIONS

Multinational Corporation (MNC) is a business organization operating in more than one country. MNC can be defined as an undertaking which owns or controls productive or service facilities in more than one country, thus excluding mere exporters, even those with established sales subsidiaries abroad, as it does more licensers of technology. MNC is also referred to as "Multinational Company" or "International Company" or"Transnational corporation".

Therefore, it can be defined as a main company (a parent company) manages a group of branches or subsidiaries in different countries to achieve certain objectives, by working together through a world managerial strategy under the constraints and laws in the home and host countries. 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.

Characteristics of Multinational Corporations

1. Geographical Spread: This geographical spread of MNCs places them in a considerable flexible position, because of the wide range of the multi-options in some decision areas, such as sourcing, pricing, financing, cash flow etc. The best MNC is able to take the advantage of changes in the economic environment internationally. The existence of networks of foreign affiliates within MNC gives the possibility of integrated production and marketing on a global basis.

2. The Efficiency: The magnitude of the available resources of MNCs enables it to distribute these resources wherever they want in different countries in the world. MNC can transport investments, money, people, machines, materials, goods, special technical knowledge and cleverness, and other services. All these are managed from a global and national perspective. This attitude of globalization in management thinking means that all affiliates are managed and controlled by the headquarters of the MNCs, but with a certain degree of the decentralization in some decision-making areas

3. The Power: The power attribute of the MNC is a result of its size, geographical spread, scope of operations, and efficiency. Today it is normal that the MNC records annual sales greater than GNP in some countries where it operates. Consequently, the MNC, as a giant among local firms, in general, has the power (at least in the economic sense) to dominate and control the local markets. Because the MNC lacks the protection of the international law, it relies upon itself to compete and win.

4. The Flexibility: According to its size and scope, the MNC is certainly the most flexible of the economic enterprises. The excellent communication systems enable the widely decentralized operations to serve the local needs, and also permit the centralized direction to assure the goal congruence. Thus, the headquarters can manipulate the mobile resources of the MNC on a global basis, based upon the best overall interests for MNC. It can produce, assemble, and market in the locations offering the best opportunity. This kind of flexibility often enables the MNC to offset or escape from restrictive regulations or controls in certain sections of the world. Transfer prices, credit terms, loans, and other points are examples of devices available to the MNC.

Advantages of Multinational Corporations

1. They ensure optimum utilization of resources both in their domestic and foreign companies.

2. They represent risk-taking enterprise for advancement, development and the provision of services.

3. They provide capital investments where urgently needed.

4. They assist the development of emerging nations and distant regions, by generating investment-multiplier effects and invisible trade.

5. They are leaders in innovation, business methods and financial practices.

6. They prove the validity of international cooperation and regional schemes.

7. They provide advanced training of staffs and opportunity for employment and career development.

8. They allow a wide participation on their investments, thereby contributing support democracy.

9. They assist in the balance of payments between developed and developing regions.

10. They lead to international mobility and trade.

11. They launch nations on a path of the self-sufficiency.

12. They provide a framework of interlocking operations and financial strategies.

Disadvantages of Multinational Corporations

1. They tend to exploit national resources.

2. They create tensions in the host countries in the political, social and economic aspects.

3. They foster excessive nationalism and anti-company feelings.

4. They exercise arbitrary control over their operations in the host countries to the exclusion of local factors.

5. They constitute crippling competition to the local enterprise.

6. They possess strong economic power and thereby exert unfair pressures and gain unfair advantages.

7. They tend to achieve economic domination over smaller economies.

8. They sometimes practice unethical business methods, such as pricing speculations, excessive royalties, loss accounting.

9. They tend to aggravate the host country's currency situation.

10. They have adverse effects on the motivation of their own staff, by the impersonal stratification of controls, thus stifle initiative and encourage risk avoidance.

11. They export capital and thereby jobs to the foreign countries.

12. They build up profits abroad at the expense of the home country.

13. They are insensitive to the local social and cultural values

MNCS AND CONSOLIDATED FINANCIAL STATEMENTS

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. The accounting issues of MNCs become numerous because of the complexity involved in managing and accounting for transactions in more than one country. These issues are discussed as follows:

1. Various accounting standards issues: accounting standards vary from one country to another and this influence significantly the overall financial reporting system of the MNCs. Although, Nigeria as adopted IFRS, not all countries have adopted as such there are differences in the recognition of intangible assets, asset measurement, financial instruments, provisions, employee benefits, deferred tax, revenue recognition, comprehensive income, and others. All these affect the consistency of the report being produced, for instance, the Last-In-First-Out (LIFO) method of inventory valuation is allowed under US GAAP and other local standards while this method is not allowed under the IFRS.

2. Foreign exchange fluctuations and translation issues: the issues of more than one country implies more than one currency, as such, there is need for the financial statements of subsidiaries in other countries to be translated to the parent's currency. The translation process sometimes can be in the form of transaction or the entire financial statements (will be discussed in module 4) which is influenced by the fluctuation in the exchange rates. These fluctuations affect the treatment of transactions in the translated financial statements.

3. Diversity in economic factors: an important macro-economic factor is level of inflation. The level of inflation in different countries influences their accounting treatments and procedures. Also, accounting systems are further influenced by tax laws which determine the treatment of financial transactions in the financial reports. These make consolidation of financial reports difficult for the MNCs.

4. Capital budgeting issues: in MNCs capital budgeting is seen to be complicated due to associated risk with future cashflows. These risks include: political, economic and financial. The political risk is the probability that unexpected political events will affect the business such as, political unrest, unfavorable changes in labour laws, etc. Economic risks include the macro-economic factors that can influence the business such as inflation, etc. Financial risk involves the undesirable changes in financial factors that will affect the business. Such factors are interest rates, exchange rate, etc. The level of risk is usually country specific.

FINANCIAL STATEMENT ANALYSIS

Analysts are employed in a number of functional areas. Commonly, analysts evaluate an investment in some type of security that has characteristics of equity (representing an ownership position) or debt (representing a lending position). In arriving at investment decisions or recommendations, analysts need to evaluate the performance, financial position, and value of the company issuing the securities. Company financial reports, which include financial statements and other data, provide the information necessary to evaluate the financial health of the company. Consequently, the analyst must have a firm understanding of the information provided in each company's financial reports, including the financial notes and other formsof supplementary information.

The role of financial statement analysis is to take financial reports prepared by companies, combined with other information, to evaluate the past, current, and prospective performance and financial position of a company for the purpose of making investment, credit, and other economic decisions.

REASONS FOR FINANCIAL STATEMENTS' ANALYSIS

There are certain themes in financial analysis. In general, analysts seek to examine the performance and financial position of companies as well as forecast future performance and financial position. Analysts are also concerned about factors that affect risks to the company's future performance and financial position. An examination of performance can include an assessment of a company's profitability (the ability to earn a profit from delivering goods and services) and its cash flow – generating ability (the ability to produce cash receipts in excess of cash disbursements). Profits and cash flows are not equivalent. Profit represents the excess of the prices at which goods or services are sold over all the costs of providing those goods and services (regardless of when cash is received or paid).

Although profitability is important, so is the ability to generate positive cash flow. Cashflow is important because, ultimately, cash is needed to pay employees, suppliers, and others to continue as a going concern. A company that generates positive cash flow from operations has more flexibility in funding needed investments and taking advantage of attractive business opportunities than an otherwise comparable company without positive cash flow. Additionally, cash flow is the source of returns to providers of capital. Therefore, the expected magnitude of future cash flows is important in valuing corporate securities and in determining the company's ability to meet its obligations. The ability to meet short - term obligations is generally referred to as liquidity, and the ability to meet long - term obligations is generally referred to as solvency.

TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS

1. Ratios

There are many relationships between financial accounts and between expected relationships from one point in time to another. Ratios are a useful way of expressing these relationships. Ratios express one quantity in relation to another (usually as a quotient). Examples of Ratios are: Profitability ratios (such as ROA, ROCE), liquidity ratio (Current ratio, acid ratio).

2. Common - Size Analysis

Common - size analysis involves expressing financial data, including entire financial statements, in relation to a single financial statement item, or base. Items used most frequently as the bases are total assets or revenue. In essence, common - size analysis creates a ratio between every financial statement item and the base item.

3. The Use of Graphs as an Analytical Tool

Graphs facilitate comparison of performance and financial structure over time, highlighting changes in significant aspects of business operations. In addition, graphs provide the analyst (and management) with a visual overview of risk trends in a business. Graphs may also be used effectively to communicate the analyst's conclusions regarding financial condition and risk management aspects.

4. Regression Analysis

When analyzing the trend in a specific line item or ratio, frequently it is possible simply to visually evaluate the changes. For more complex situations, regression analysis can help identify relationships (or correlation) between variables. For example, a regression analysis could relate a company's sales to gross domestic product (GDP) over time, providing insight into whether the company is cyclical. In addition, the statistical relationship between sales and GDP could be used as a basis for forecasting sales.

ACT 416

INTERNATIONAL ACCOUNTING 11

PERFORMANCE EVALUATION IN MNCS

Learning Objectives

By the end of the lesson, the student should be able to:

1. Discuss the concept of performance evaluation
2. Highlight financial measures used by MNCs to evaluate domestic and foreign subsidiaries
3. Discuss issues to consider when developing MNC evaluation systems
4. Explain the relationship between responsibility accounting and performance evaluation

Main Content

MEANING OF PERFORMANCE EVALUATION

Performance evaluation is the periodic review of operations to ensure that the objectives of the enterprise are being accomplished. It is a multi-purpose tool used to measure actual performance against expected performance, provide an opportunity for the employee and the supervisor to exchange ideas and feelings about job performance, identify employee training and development needs, and plan for career growth. Performance evaluations are important tools used by management to review and discuss employees' performances.

Benefits result from the Performance Evaluation process:

Control of the work that needs to be done

Enhancement of employee motivation, commitment, and productivity

- Identification of goals and objectives for the employee
- Satisfaction of the basic human need for recognition
- Identification of process improvement opportunities
- Identification of employee development opportunities

FINANCIAL MEASURES USED BY MNCS TO EVALUATE DOMESTIC AND 61 FOREIGN SUBSIDIARIES

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

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 gross 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

The ability to reach customers is vital to company's long-run success. Customer acceptance of company's products or services translates directly into the sales (or revenue) figure. Sales growth may also indicate increased market share. Because of an increase in globalization leading to high competition in the 1990s, cost reduction intensified. Cost reduction is the minimization of associated cost using certain techniques, an example is outsourcing functions such as accounting and information technology. 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.

ISSUES TO CONSIDER WHEN DEVELOPING MNC EVALUATION SYSTEMS

From previous studies and literatures it can be concluded that MNCs and their subsidiaries operate in different international environments, and the performance of the foreign subsidiaries is affected by some variables and factors such as: environmental factors (economic, legal, political, technological, cultural and social), transfer pricing, foreign currencies, and inflation. If the MNC want to evaluate the real performance of the foreign subsidiaries and their managers it must

consider these factors and variables at performance evaluation process of foreign subsidiaries and their managers.

1. Transfer Pricing

The transfer price (internal price) is the price at which goods and services are transferred (bought or sold) between members of MNC, for example, from parent to subsidiaries, between subsidiaries, and from subsidiaries to parent. The MNC often sets the transfer prices to maximize the global after-tax income or otherwise manoeuvre profits to lower tax rate countries. The issue of transfer pricing in MNC is complicated by the fact that tax and custom authorities of different countries take an active interest in the 63 methods employed. Furthermore, MNCs can use transfer prices in a similar manner to reduce the impact of tariffs. Tariffs increase import prices and apply to inter-corporate transfers as well as to sales to unaffiliated buyers. Although no company can do much to change tariffs, the effect of tariffs can be lessened, if the selling company under-prices the goods it exports to the buying company

2. Foreign Currencies

The accounting records and financial statements of the foreign subsidiaries are generally maintained in the subsidiary's local currency. The parent company must be able to translate these foreign currency financial statements to the currency of the parent company. The choice of currency, in which to evaluate the performance, is one of the problems of performance measurement and evaluation of foreign subsidiaries and their managers. The MNC needs to translate the financial statements of its foreign subsidiaries for many reasons: (1) to record the transactions that are measured in a foreign currency, (2) to prepare consolidated financial statements which report on the economic entity as a whole, (3) to evaluate the operations of a foreign business segment, (4) to evaluate the performance of the management of the foreign subsidiaries, (5) to direct and control the foreign operations, and (6) for the convenience of users whether they are internal or external users.

3. Inflation

Inflation is one of the environmental factors, which affecting the performance of multinational companies. It is considered as one of the variables (problems) that are out of control of subsidiary management. During inflation periods, the figures and information in the financial statements and

reports are misrepresentative and may mislead the decision 64 makers; consequently, they affect the performance of the company. Thus, the multinational company must consider the effect of inflation on the financial statements and reports of the company, if it wants to measure and evaluate the real performance of foreign subsidiaries in the host countries. Doubtless, high inflation rates render accounting numbers fairly useless for performance evaluation.

4. The effect of the environmental factors:

The foreign subsidiaries operate in different international environments. Each environment may have economic, legal, political, cultural and social factors different from those in other environments. Because of these environmental factors it is possible to have a good management performance despite poor subsidiary performance, and vice-versa. Thus, if the MNC want to evaluate the real performance of foreign subsidiaries and their managers, it must eliminate the effect of these environmental factors from the performance of the foreign subsidiaries and their managers.

RESPONSIBILITY ACCOUNTING AND PERFORMANCE EVALUATION IN MNCs

Responsibility accounting is a controlling system under management accounting where responsibilities are assigned to control unnecessary costs. Responsibility accounting is a kind of management accounting that is accountable for all the management, budgeting, and internal accounting of a company. The primary objective of this accounting is to support all the Planning, costing, and responsibility centres of a company.

Responsibility Accounting is management accounting where all the company's management, budgeting, and internal accounting are held responsible. The primary objective of responsibility accounting is to hold responsible all the concerned departments of any particular function.
In this type of accounting system, responsibility is assigned on the basis of the knowledge and skills of the individuals. The basic motive of responsibility accounting is to decrease the overall cost and increase the overall profit. If the motives do not get fulfilled, the concerned people are held accountable and answerable

Advantages of Responsibility Accounting:

- It urges the management to acknowledge the company structure and checks who is accountable for what and fix the problems.

- It enhances attention and awareness of the managers as they have to explain the variations for which they are responsible.
- It helps to compare the achievements between the pre-planned goals and actual results.
- It creates a sense of efficiency within individual employees as their work and achievements will be reviewed.
- It guides the management to plan and structure the future expenditure and revenue of a company.
- Being a cost control tool, it creates 'cost consciousness' among workers.
- Individual and company goals are established and communicated in the best way.
- It improves and controls the company's operating activities for an effective and efficient outcome.

Types of Responsibility Center

A responsibility center is a functional business entity that has definite objectives and goals, dedicated personnel, procedures, and policies as well as the duty of generating a financial report. Some basic responsibility centers that all organisations generally need are Cost center, Profit center, Revenue Center and Investment Center.

Cost Center

A cost center is responsible for cost control. The main objective of the cost center is to minimize cost. The cost centre's prime work is to check the cost of an organisation and to limit the unwanted expenditure that the company may acquire. Costs, in this respect, are basically classified as controllable costs and non-controllable costs. Controllable costs are the costs that can be controlled by the organization. Uncontrollable costs are the cost that the organization cannot control. The concerned center is made responsible and accountable for only controllable expenses. So, it is important to distinguish between controllable costs and non-controllable costs. The performance evaluation is done on the basis of the actual cost that occurred and the targeted cost. Some types of costs centers are:

- Production Cost Center
- Personal Cost Center
- Service Cost Center

- Impersonal Cost Center
- Process Cost Center
- Operation Cost Center

Performance evaluations of cost centers are primarily financial and focus upon variances from predetermined standards. The better systems are based upon reasonably attainable standards, tailored to suit the responsibility centers, and revised as conditions change

Revenue Center

This center is basically inclined towards the generation of leads and subsequently increasing the overall revenue of the firm. Company's sales team is mainly held responsible for this. A revenue center is judged solely on its ability to generate sales; it is not judged on the amount of costs incurred. Revenue centers are employed in organisations that are heavily sales focused. Performance evaluation usually begins with financial comparisons of actual and budgeted levels of revenues and expenses, after variable portion of the latter have been adjusted to reflect actual activity levels.

Profit Center

A profit center refers to a center whose performance is measured in cost and revenue both. It contributes to both revenue and expenses, resulting in profit and loss. Profit occurs when revenues are more than costs and loss occurs when costs are more than profits. The profit center is accountable for all the actions associated with the sale of goods and production. The principle objective of a profit center is to generate and maximize profit by minimising the cost incurred and increasing sales. Performance evaluations relate outputs (revenues) with inputs (costs and expenses) by focusing on profits (revenues minus identifiable expenses).

Below are the steps involved in responsibility accounting.

1. Defining responsibility or cost center.
2. Tracking the actual performance of each responsibility center.
3. Comparing actual performance with the target performance.
4. Analyzing the variance between actual performance and target performance
5. Fixing responsibilities for each center after variance analysis

ACT 416

INTERNATIONAL ACCOUNTING II

ACCOUNTING FOR FOREIGN OPERATIONS (CONTD)

Learning Objectives

At the end of the lesson, the students should be able to:

1. Describe foreign exchange translation

2. Describe the methods of foreign exchange translation

Main Content

FOREIGN CURRENCY TRANSLATION OF DIRECT BUSINESS TRANSACTIONS

An entity may carry on foreign activities in two ways – transactions and translation. In addition it may present its financial statements in a foreign currency. IAS 21 prescribes how transactions and foreign operations should be accounted and how to translate financial statements into a presentation currency. In preparing consolidated financial statements on a worldwide basis, the foreign currency financial statements prepared by foreign operations must be translated into the parent company's reporting currency.

A. The two major issues related to the translation of foreign currency financial statements are: (1) which method should be used, and (2) where should the resulting translation adjustment be reported in the consolidated financial statements.
B. Translation methods differ on the basis of which accounts are translated at the current exchange rate and which are translated at historical rates. Accounts translated at the current exchange rate are exposed to translation adjustment (balance sheet exposure).
C. Different translation methods give rise to different concepts of balance sheet exposure and translation adjustments of differing sign and magnitude.

There are situations where a business enters into a contract with a foreign currency and there arise the need to translate such transaction into the functional currency of the business for presentation purpose. Examples of such transactions are: Imports of raw materials, Exports of finished goods, Importation of non-current assets, Investments on foreign securities, Obtaining foreign loan, etc.

Such transactions may be required to be translated at more than one time in the accounts, for instance, the credit purchase of raw materials will affect the books and the subsequent payment will also affect the books especially in the era of exchange rate fluctuations. Also, the domestic value of an overseas long-term loan is likely to fluctuate from period to another.

The method of translation is as follows:

i. Transactions during Accounting Period: These should be translated and recorded at the rate of exchange ruling at the date of the transaction. In practice, an average rate might be used.

ii. Monetary Items at reporting date: Where these items such as receivables, payables, bank balances or loans are denominated in a foreign currency they should be translated and recorded at the closing rate or, if appropriate, at the rate at which the transaction is contracted to be settled that is at an agreed forward rate.

iii. Non-monetary items at reporting date: where these items are carried at cost less depreciation, they should be translated and recorded at the exchange rate at the date of acquisition. Where these items are carried at fair value less depreciation, they should be translated and recorded at the exchange rate at the date of revaluation.

Exchange difference: All exchange difference should be reported as part of profit for the year.

It is also important to differentiate between functional currency and presentation currency. IAS 21 suggests that when determining its functional currency, the entity has to consider the primary economic environment where an entity operates in which it primarily generates and expends cash.

ILLUSTRATION I

An entity operating in Nigeria has various buildings in Ghana that are determined in US Dollars and payments can be made in US dollars or cedes. Determine the entity's functional currency

Solution

The functional currency is Cedes because;

1. The local circumstances in Ghana determine the rental yield.

2. Presumably labour and other expenses are paid in Cedes

ILLUSTRATION 2

On 20 October 2016 an entity with a functional currency of Naira buys raw materials from a supplier on credit for $1,000. At the end of the accounting period the entity is yet to pay the debt. The entity has a financial year-end of 31 December 2016.

The spot exchange rates are as follows:

- 20 October 2016: ₦250/$1
- 31 December 2016: ₦280/$1

Required: show the journal entries for the above transactions at initial recognition and end of the year

Solution

At initial recognition: the purchase is recorded on 20th October, 2016 as follows:

	Dr(₦)	Cr(₦)
Purchases ($1000*₦250)	250,000	
Trade Payable ($1,000*₦250)		250,000

Being the initial recognition of purchase of raw materials

On 31st December 2016, the trade payables will be retranslated at the closing rates as follows: $1,000*₦280= ₦280,000

Exchange rate difference amount to:

₦280,000-₦250,000= ₦30,000

Thus;

	Dr(₦)	Cr(₦)
Profit or loss (Exchange difference)	30,000	
Trade Payable (Exchange difference)		30,000

Being the exchange rate difference arising from the credit purchase of raw materials during the year

Note: the trade payables will reflect ₦280,000 at the end of the period while if the raw materials have not been used, sold or impaired will still be recognized at ₦250,000.

ILLUSTRATION 3

BUK PLC, a Nigerian multinational company whose functional currency is Naira (₦) with an accounting year-end of 31st December of each year purchased raw materials on credit from Smart Inc. of the United States of **America** invoiced at $10,000 on 2nd April 2015, when the exchange rate was ₦171= US$ 1. BUK PLC settled its account on 30th July 2015 when the exchange rate was ₦195=US$1. *You are required to show the foreign currency gain(s) or losse(s) to BUK PLC by way of journal entries.*

Solution to Illustration 3

In the Books of BUK PLC

General Journal

Particulars	Dr.	Cr.
	₦	₦
Purchases	1,710,000	
Smart Inc.		1,710,000
Being credit purchases for US$10,000 at exchange rate of ₦171= US$ 1		
Smart Inc.	1,710,000	
Profit & Loss (exchange loss)	240,000	
Bank		1,950,000
Being payment for credit purchases for US$10,000 at exchange rate of ₦195= US$ 1		

Illustration 4

GSU Limited whose functional currency is Naira (₦) with an accounting year-end of 31st December of each year purchased raw materials on credit from Galaxy PLC of Accra, Ghana invoiced at ₵100,000 on 1st April 2015, when the exchange rate was ₦ 1=₵1.58 . As at 31st December, 2015, the end of its Accounting year, GSU Ltd did not settle Galaxy PLC. As at that date the exchange rate was ₦ 1=₵1.52. *You are required to record these transactions in the books of GSU Limited by means of a journal showing how the exchange rate fluctuation would be accounted for by December 31, 2015.*

Solution to Illustration 4

In The Books of GSU PLC

General Journal

Particulars	Dr.	Cr.
	₦	₦
Purchases	63,291	
Galaxy PLC		63,291
Being credit purchases for ₵100,000 at exchange rate of ₦ 1= ₵1.58		
Dr. P&L (Exchange fluctuation loss)	2,499	
Cr. Galaxy PLC		2,499
Being exchange rate fluctuation to December 31, 2015 on credit purchases for ₵100,000 at exchange rate of ₦1= ₵1.52		

1st April 2015 ₵100,000/1.58= ₦63,291

31st Dec. 2015 (₵100,000/1.52)- 63, 291 = ₦2,499

IAS 21 AND FINANCIAL STATEMENT TRANSLATION OF FOREIGN OPERATIONS: FOREIGN BRANCHES

Learning Objectives

At the end of the lesson, the student should be able to:

1. Discuss the methods of financial statements translation
2. Explain the ways to determine the method to adopt
3. Translate the financial statements of a branch

Main Content

METHODS OF TRANSLATION

The IAS 21 does not give an enterprise the freedom to choose which method of translation should be used. It lays down the circumstances in which each particular method must be used. There are basically three methods as provided in the standards and these are explained as follows:

i. Closing rate method: This method is to be used when the foreign operations do not form an integral part of the activities of home company. Under this method:

Item	Translation Rate
Assets and Liabilities	Closing Rate
Item of Profit or Loss	Closing Rate

The method is also referred to as current rate method. Arising exchange difference will be adjusted to reserves. Under the current rate method, all assets and liabilities are translated at the current exchange rate giving rise to a balance sheet exposure equal to the foreign subsidiary's net assets. Stockholders' equity accounts are translated at historical exchange rates. Income statement items are translated at the average exchange rate for the current period

2. Temporal Method

This method is used when foreign operations form an integral part of the activities of home country company. Under the temporal method, assets are carried at current or future value (cash, marketable securities, receivables) and liabilities are remeasured at the current exchange rate. Assets carried at historical cost and stockholders' equity accounts are remeasured at historical exchange rates. Expenses related to assets remeasured at historical exchange rates are remeasured

using the same rates. Other income statements items are remeasured using the average exchange rate for the period Here:

Item	Translation Rate
Current Assets and Liabilities	Closing Rate
Non-Current Assets and Liabilities	Historical Rate
Statement of Comprehensive Income	Average Rate

This method is sometimes referred to as current-non-current method. Arising exchange difference will be adjusted to statement of Comprehensive Income.

iii. Monetary and non-monetary: Under this method, monetary assets and liabilities are translated to the rate ruling at the Reporting date and non-monetary assets and liabilities at the historical rate at the date they were acquired or incurred. Assets and liabilities are regarded as monetary if their nominal values are fixed.

DETERMINATION OF METHOD TO ADOPT

The method to be used will be determined by the business of the home country in association with the foreign operations. Some of the clues include:

- When goods sent to the branch by the head office constitute a high proportion of goods by the branch, then the temporal method is used while closing method will be suitable if otherwise.
- If the branch relies on funding from the head office, the temporal method is suitable while the closing method should be used if the branch is independent in terms of funding. (Shiyanbola, 2015)

ILLUSTRATION I

Shugarine Enterprise operates in Nigeria with a branch in Ghana, Dudu Enterprise. The financial statements prepared in Cede (Ghana Currency) were as follows:

Dudu Enterprises

Statement of Profit or Loss for the year ended 31st December, 2016

	Cedi	Cedi
Turnover		850,000

Less cost of sales			
Opening Inventory		355,750	
Add purchases		120,500	
		476,250	
Closing Inventory		206,420	(269,830)
Gross Profit			**580,170**
Depreciation		**18,000**	
Operating Expenses		**142,820**	**(160,820)**
Net Profit			**419,350**

Dudu Enterprises

Statement of Financial Position as at 31st December, 2016

Non-Current Assets (Net Book Value)		**Cedi**	**Cedi**
Furniture & Fittings		562,000	
Motor Vehicles		120,000	682,000
Current Assets			
Closing Inventory		206,420	
Account receivables		110,000	
Cash at Bank		85,000	
		401,420	
Current Liabilities			
Current Account	128,500		
Account Payables	140,000	(268,500)	132,920\
			814,920
Financed By			
Retained Profits			634,700
Long term debts			180,220
			814,920

Additional information for the period was given as follows:

- The head office current account and the tangible assets were agreed at when the exchange rate was ₦0.20/1cedi on 01/01/2014.
- On 1/1/2016 the retained earnings was ₦23,500
- The exchange rates for cedi during the period were: 1/1/2016 ₦0.56/1cedi 31/12/2016 ₦0.73/1cedi

Required: Translate the financial statement of Dudu Enterprises into Naira using temporal method.

Solution

Dudu Enterprises

Statement of Profit or Loss for the year ended 31st December, 2016

	Cedi	Cedi	Rate	N	N
Turnover		850,000	0.645		548,250
Less cost of sales					
Opening Inventory	355,750		0.56	199,220	
Add Purchases	120,500		0.645	77,723	
	476,250			276,943	
Closing Inventory	(206,420)	(269,830)	0.73	(150,687)	(126,256)
Gross Profit		580,170			421,994
Depreciation	18,000		0.2	3,000	
Operating Expenses	142,820	-160,820	0.645	92,119	(95,719)
Net Profit		419,350			326,275
Exchange Loss (wk 2)					(179,799)
Retained Earnings (wk 1)					146,476

Dudu Enterprises

Statement of Financial Position as at 31st December, 2016

Non-Current Assets	Cedi	Cedi	Rate	N	N
Furniture & Fittings	562,000		0.2	112,400	
Motor Vehicles	120,000	682,000	0.2	24,000	136,400
Current Assets					
Closing Inventory	206,420		0.73	150,687	

Account receivables		110,000		0.73	80,300
Cash at Bank		85,000		0.73	62,050
		401,420			293,037
Current Liabilities					
Current Account	128,500			0.2	25,700
Acc Pay	140,000	-286,500	132,920	0.73	102,200
			814,920		301,537
Financed By					
Retained Profit		634,700	Derived	0.73	169,976
Long Term Debts		180,220		0.73	131,561
		814,920			301,567

Workings	₦
1. Retained earnings (derived)	169976
Less balance as at 1/1/2016	-23500
Net increase in retained earnings	146476
2. Net Profit derived	326,275
Less net increase in retained earnings	(146476)
Exchange loss	79,799

3. Average rate= (0.56+0.73)/2 =0.645

ACT 416

ACCOUNTING FOR FOREIGN OPERATIONS

Learning Objectives

At the end of this lesson, the student should be able to:

1. Define Foreign Currency Translation

2. Discuss the terminologies used in financial statements translation

3. Highlight direct business transactions and their treatment

Main Content

Definition of Terminologies

Closing Rate: this is the exchange rate at the reporting date which is end of the reporting period.

Opening Rate: this is the exchange rate at the beginning of the reporting period.

Monetary Items: are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency

Foreign currency is a currency other than the functional currency of the entity

Spot exchange rate is the exchange rate for immediate delivery.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Presentation currency: The currency in which the financial statements are presented

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

Functional currency: this is the currency of the primary economic environment in which the entity operates. This currency is the primary currency in which all the transaction of

inflow and outflow takes place, basically the primary economic environment in which the business operates. This currency may be different from the currency used by its parent company or subsidiary

A foreign subsidiary: is a subsidiary whose activities are based and conducted in a country other than the country of the parent. Such as subsidiary may not constitute a foreign entity.

A Foreign Entity: is a foreign operation whose activities are not in integral part of those of the parent.

Exchange Rate: This could be defined a ratio at which the currencies of two countries are exchanged at a particular date

Forward Rate: The exchange rate available by the terms of an agreement for the exchange of two currencies at a future date.

A transaction that requires payment or receipt (settlement) in a foreign currency is called a ***foreign currency transaction***. Foreign currency transactions are those transactions whose terms are denominated in a currency other than the entity's functional currency. A foreign currency transaction will be settled in a foreign currency, and the Nigerian firm is exposed to the risk of unfavorable changes in the exchange rate that may occur between the date the transaction is entered into and the date the account is settled. A firm may ***hedge***, that is, protect itself against an unfavorable change in the exchange rate by using derivatives. Foreign currency transactions may result in receivables or payables fixed in terms of the amount of foreign currency to be received or paid. When companies in different countries engage in activities with one another, the activities often involve the use of different currencies. For example, the Nigerian currency is Naira, the United States currency is the dollar, while the British currency is the pound, and the French currency is the euro. The relationship between the currencies of different countries changes over time. As such, transaction gains and losses are reported in the income statement.

An ***exchange rate*** is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. A ***direct exchange***

quotation is one in which the exchange rate is quoted in terms of how many units of the domestic currency can be converted into ***one unit of foreign currency***. For example, a direct quotation of Nigerian Naira for one US dollar of 153 means that ₦153 could be exchanged for one US dollar.

Exchange rates may be quoted either as a spot rate or a forward rate. The **spot rate** is the rate currencies can be exchanged today. The ***forward*** or ***future rate*** is the rate the currencies can be exchanges at some future date. The forward rate is an exchange rate established at the time a forward exchange contract is negotiated. A ***forward exchange contract*** is a contract to exchange at a specified rate (the ***forward rate***) currencies of different countries on a stipulated future date. Before the currencies are exchanged, the spot rate may move above or below the contracted forward exchange rate, but this has no effect on the forward rate established when the forward exchange contract was negotiated.

Similarly, Exchange rates may also be quoted either as official (fixed) rates or floating rates. The official rate is the rate the country maintains the actual exchange rate of its currency within 2% of the official rate. The floating rate is the currency's exchange rate that is determined by supply and demand factors, which increases risk to companies doing business with a foreign company.

Foreign Currency Transactions

Foreign currency transactions take place when a company:

1. buys or sells on credit goods or services the prices of which are denominated in foreign currencies;
2. borrows or lends funds, and the amounts payable or receivable are denominated in a foreign currency;
3. is a party to an unperformed forward exchange contract; and
4. acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currencies.

Transactions are normally ***measured*** and recorded in terms of the currency in which the reporting entity prepares its financial statements. This currency is usually the domestic currency of the country in which the company is domiciled and is called the ***reporting currency***

FOREIGN CURRENCY TRANSLATION OF DIRECT BUSINESS TRANSACTIONS

There are situations where a business enters into a contract with a foreign currency and there arise the need to translate such transaction into the functional currency of the business for presentation purpose. Examples of such transactions are: Imports of raw materials, Exports of finished goods, Importation of non-current assets, Investments on foreign securities, Obtaining foreign loan, etc.

Such transactions may be required to be translated at more than one time in the accounts, for instance, the credit purchase of raw materials will affect the books and the subsequent payment will also affect the books especially in the era of exchange rate fluctuations. Also, the domestic value of an overseas long-term loan is likely to fluctuate from period to another.

The method of translation is as follows:

i. Transactions during Accounting Period: These should be translated and recorded at the rate of exchange ruling at the date of the transaction. In practice, an average rate might be used.

ii. Monetary Items at reporting date: Where these items such as receivables, payables, bank balances or loans are denominated in a foreign currency they should be translated and recorded at the closing rate or, if appropriate, at the rate at which the transaction is contracted to be settled that is at an agreed forward rate.

iii. Non-monetary items at reporting date: where these items are carried at cost less depreciation, they should be translated and recorded at the exchange rate at the date of acquisition. Where these items are carried at fair value less depreciation, they should be translated and recorded at the exchange rate at the date of revaluation.

ILLUSTRATION 1

An entity operating in Nigeria has various buildings in Ghana that are determined in US Dollars and payments can be made in US dollars or cedes. Determine the entity's functional currency

Solution

The functional currency is Cedes because;

1. The local circumstances in Ghana determine the rental yield.

2. Presumably labour and other expenses are paid in Cedes

ACT 416

INTERNATIONAL FINANCIAL REPORTING

Learning Objectives

At the end of the lesson, the student should be able to:

1. To learning the meaning and objectives of Financial Reporting

2. To understand the scope of Financial Reporting

3. To know the difference between IFRS and US GAAP

Main Content

IFRS stands for International Financial Reporting Standards. These are a set of accounting standards developed by the International Accounting Standards Board (IASB), an independent, private-sector body based in London. IFRS provides a comprehensive framework for the preparation and presentation of financial statements for public companies across the globe. The primary goal of IFRS is to establish a common global language for financial reporting, making it easier for investors and other stakeholders to compare financial performance across different companies and countries. Adoption of IFRS enhances transparency, accountability, and comparability in financial reporting, thereby facilitating investment decisions and fostering confidence in capital markets.

IFRS covers various aspects of financial reporting, including recognition, measurement, presentation, and disclosure of financial information. It addresses a wide range of topics such as revenue recognition, leases, financial instruments, and business combinations, among others. IFRS is continually updated and revised by the IASB to reflect evolving business practices, economic developments, and regulatory requirements globally.

Objectives of IFRS

1. The main objective of IFRS is to develop in the public the interest of 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; in fulfilling the objectives associated with it.

3. To take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies.

4. To bring about convergence of national accounting standards and International Accounting standards and IFRS to high quality solutions.

Scope of IFRS

The scope of IFRS (International Financial Reporting Standards) is broad, encompassing various aspects of financial reporting across different industries and sectors. They include:

Financial Statements: IFRS provides guidance on the preparation and presentation of financial statements, including the balance sheet, income statement, statement of changes in equity, and cash flow statement. It specifies the format, content, and disclosures required in these financial statements to ensure transparency and comparability.

Recognition and Measurement: IFRS establishes principles for the recognition and measurement of assets, liabilities, income, and expenses. It outlines criteria for determining when items should be recognized in the financial statements and how they should be measured, including historical cost, fair value, and present value techniques.

Revenue Recognition: IFRS includes comprehensive guidance on revenue recognition, specifying principles for recognizing revenue from the sale of goods, rendering services, and other types of transactions. It addresses issues such as multiple-element arrangements, long-term contracts, and revenue from contracts with customers.

Leases: IFRS 16, the standard on leases, provides guidance on the accounting treatment for leases by lessees and lessors. It requires lessees to recognize most leases on their balance sheets as a right-of-use asset and a lease liability, eliminating the distinction between finance and operating leases for lessees.

Financial Instruments: IFRS covers the accounting for various types of financial instruments, including financial assets, financial liabilities, and derivatives. It addresses topics such as

classification and measurement, impairment, hedge accounting, and disclosures related to financial instruments.

Consolidation and Business Combinations: IFRS provides guidance on the accounting for business combinations, including the determination of the acquirer, recognition and measurement of identifiable assets acquired and liabilities assumed, and the treatment of goodwill. It also addresses the consolidation of subsidiaries and other investments.

Disclosure Requirements: IFRS sets out extensive disclosure requirements aimed at providing users of financial statements with relevant and transparent information about an entity's financial position, performance, and cash flows. Disclosures cover a wide range of topics, including significant accounting policies, risks and uncertainties, related party transactions, and segment reporting.

Difference Between IFRS and US GAAP Standards

Key differences between International Financial Reporting Standards (IFRS) and United States Generally Accepted Accounting Principles (US GAAP).

Aspect	IFRS	US GAAP
Geographic Scope	Adopted by over 140 countries worldwide	Primarily used in the United States
Standard-Setting Bodies	IASB (International Accounting Standards Board)	FASB (Financial Accounting Standards Board)
Inventory Valuation	LIFO (Last-In, First-Out) is prohibited	LIFO is allowed for inventory valuation.
Revenue Recognition	IFRS 15 (IFRS) and IAS 18 (previous standard) for revenue recognition	ASC 606 (US GAAP) for revenue recognition
Presentation of Financial Statements	IFRS focuses on the statement of financial position, statement of profit or loss and other comprehensive income,	US GAAP includes the balance sheet, income statement, statement of comprehensive income, and

	and statement of changes in equity.	statement of stockholders' equity.
Earnings Per Share	IFRS uses the basic and diluted earnings per share calculations.	US GAAP uses basic, diluted, and two-class methods for calculating earnings per share.

Generally accepted accounting principles (GAPP)

Generally accepted accounting principles (GAAP) is the accounting standard set by the Financial Accounting Standards Board (FASB) for the Securities and Exchange Commission (SEC) in the United States. It's a rule-based system that all domestic and Canadian publicly traded companies must follow when filing financial statements. The purpose of GAAP is to help investors analyze financial data and compare different companies to make informed financial decisions.

International Financial Reporting Standards (IFRS) International Financial Reporting Standards (IFRS) are the accounting standards set by the International Accounting Standards Board (IASB). It's a set of guidelines followed by 15 of the G20 countries. China, India, and Indonesia do not follow IFRS accounting standards but have similar standards, while Japan allows companies to follow IFRS standards if they choose.

While GAAP and IFRS both pertain to how financial documents are structured and filed, there are significant differences.

The two main distinctions are:

Enforcement: GAAP is rule-based, meaning publicly traded US companies are lawfully required to follow its directives. On the other hand, IFRS is standard-based, meaning no one is required to follow its guideline though it's recommended. As a result, the theoretical framework and principles of IFRS leave more room for interpretation and sometimes require lengthy disclosures on financial statements.

Source and scope: GAAP is US-based, while IFRS is used worldwide. The IASB, which sets IFRS, is globally influential; its accounting standards are adapted to accounting rules in countries

worldwide. The US, where the Securities and Exchange Commission requires American companies to use GAAP when preparing their financial statements, is the only exception.

Inventory valuation methods:

Inventory valuation figuring out how much your inventory is worth. There are three standard accounting methods for doing this: the first in, first out (FIFO) method which assumes that the first (or oldest) items in your inventory will be the first to sell; the last in first out (LIFO) method, which assumes that the last (or newest) items in your inventory will be the first to sell; and the weighted average method, which uses the amount earned from selling a portion of your inventory to determine the value of the remaining portion. Here's how GAAP and IFRS differ when it comes to inventory valuation methods:

GAAP allows companies to use any of the three inventory valuation methods. When using FIFO, GAAP uses "net asset value" the total value of a company's assets minus the total value of its liabilities to determine inventory valuation.

IFRS allows the FIFO and weighted average method but does not allow the LIFO method, because LIFO can be manipulated to distort a company's earnings to lower tax liability. When using FIFO, IFRS uses "net realizable value," which considers how much an asset might generate when sold, minus an estimate of costs, fees, and taxes associated with the sale

A cash flow statement:

Cash flow statement is a financial statement that shows precisely how cash and cash equivalents enter and exit a business over a specific reporting period. GAAP and IFRS handle cash flow statements differently, particularly in how they classify interest and dividends:

- With GAAP, interest paid and received, and received dividends are listed under the operating section, while dividends paid are listed in the financing section.

- With IFRS, all interest and dividends can be listed under the operating or financing section.

Balance sheet:

A balance sheet is a financial statement that summarizes a company's assets, liabilities, and shareholder equity at a given point in time. It's essential to know how to organize your balance

sheet so that your investors and other interested parties can quickly and accurately read it. GAAP and IFRS differ in how categories are arranged on a balance sheet:

• GAAP requires assets in order of liquidity, with the most liquid assets listed firstthat is, current assets, non-current assets, current liabilities, non-current liabilities, and owners' equity.

• IFRS suggests putting assets in the opposite order of liquidity, with the least liquid assets listed first that is, non-current assets, current assets, owners' equity, non-current liabilities, and current liabilities.

Asset revaluation:

The value of a company's assets may fluctuate over a given period, meaning they need to be re-evaluated (i.e., reappraised). Asset revaluation is crucial because it can help you save for replacement costs of fixed assets once they've run through their useful lives, and gives investors a more accurate understanding of your business. Asset revaluation can also reduce your debt-toequity ratio, which can paint a healthier financial picture of your company.

• IFRS have different approaches to asset revaluation: GAAP only allows the revaluation of fair market value for marketable securities (i.e., investments and stocks).

• IFRS allows for the revaluation of more assets, including plant, property, and equipment (PPE), inventories, intangible assets, and investments in marketable securities.

Financial Reporting under US GAAP:

Financial Reporting refers to the reporting of the activities of an entity in terms of parts or segments or operations. GAAP require segment reporting for publicly held companies by products, industries, customers, geographic area, etc., and are covered in the following pronouncements (Financial Accounting Statements series issued by FASB):

• FAS-14 Financial Reporting for Segments of a Business Enterprise.

• FAS-18 Financial Reporting for Segments of a Business Enterprise - Interim Financial Statements.

- FAS-21 Suspension of the Reporting of Earnings per share and Segment Information by Non-public Enterprise.

- FAS-24 Reporting Segment Information in Financial Statements that are Presented in another Enterprise's Financial Report.

- FAS-30 Disclosure of Information about Major Customers requires that annual.

Benefits of IFRS

Some of the benefits of adopting IFRS:

- Transparency and comparability
- Low cost of capital
- Eliminates need for multiple reporting
- True value of acquisition
- Cross border transaction
- Sets a benchmark
- Improvement in planning and forecasting

ACT 416

SEGMENT REPORTING

Learning Objectives

At the end of the lesson, the student should be able to:

1. To Understand the objective and key aspects of segment reporting

2. To know the scope of segment reporting

3. To learn the components of segment reporting

4. To identify the reportable segments

5. To study the format of segment reporting

Main Content

A segment is a component of a business that generates its own revenues and creates its own product, product lines, or service offerings. A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

Segment reporting breaks down the operations of a company into manageable pieces, or segments. Public companies must then record detailed financial statements for each operating segment. Segment reporting is a financial reporting requirement that entails breaking down a company's financial information into various segments or business units. These segments are typically based on the company's internal organizational structure or the way management assesses performance and allocates resources. Segment reporting provides stakeholders with more detailed insights into the company's operations, helping them understand the performance and risks associated with each segment.

The goal is to increase transparency for creditors and investors, especially regarding the company's most important operating units.

Factors that should be considered in determining whether products or services are related include:

a. the nature of the products or services;

b. the nature of the production processes;

c. the type or class of customers for the products or services;

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

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

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

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

(e) exchange control regulations; and

(f) the underlying currency risks

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

Segment revenue is the aggregate of

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

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

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

Segment revenue does not include:

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

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

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

Segment expense is the aggregate of:

i. the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

ii. the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise

Segment expense does not include:

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

b. interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature; Explanation: The interest expense relating to overdrafts and other operating liabilities identified to a particular segment are not included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories. In case interest is included as a part of the cost of inventories where it is so required as per AS 16, Borrowing Costs, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest is considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest is disclosed by way of a note to the segment result.

c. losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

d. income tax expense; and e. general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets. Segment assets do not include income tax assets. Segment assets are determined after deducting related allowances/ provisions that are reported as direct offsets in the balance sheet of the enterprise. Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities. Segment liabilities do not include income tax liabilities. Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to.

Examples of segment assets include current assets that are used in the operating activities of the segment and tangible and intangible fixed assets. If a particular item of depreciation or amortization is included in segment expense, the related asset is also included in segment assets. Segment assets do not include assets used for general enterprise or head-office purposes. Segment assets include operating assets shared by two or more segments if a reasonable basis for allocation exists. Segment assets include goodwill that is directly attributable to a segment or that can be allocated to a segment on a reasonable basis, and segment expense includes related amortization of goodwill. If segment assets have been revalued subsequent to acquisition, then the measurement of segment assets reflects those revaluations.

Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services. Segment liabilities do not include borrowings and other liabilities that are incurred for financing rather than operating purposes. The liabilities of segments whose operations are not primarily of a financial nature do not include borrowings and similar liabilities because segment result represents an operating, rather than a net-of-financing, profit or loss. Further, because debt

is often issued at the head-office level on an enterprise-wide basis, it is often not possible to directly attribute, or reasonably allocate, the interest-bearing liabilities to segments

Scope of segment reporting

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

Segment result:

Segment result is segment revenue less segment expense. Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investment, or other income-producing assets. Segment assets do not include income-tax assets. Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities. Segment liabilities do not include income tax liabilities.

Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting. Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.

Business Segment:

Business segment is a distinguishable unit of an enterprise engaged in providing individual product or service or a group of related products or services. Further, it is subject to risk and returns that are different from those of other business segments

A business segment or geographical segment is identified as a reportable segment if:

- revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue of all segments

- Segment result is 10% or more of the following whichever is greater in absolute amount:

- combined result of all segments in profit

- combined result of all segments in loss

- Segment assets are 10% or more of total assets of a segment

ACT 416

TRANSFER PRICING

Learning Objectives

At the end of the lesson, the student should be able to:

1. Define Transfer Pricing
2. Discuss the Features of Transfer Pricing
3. Discuss the various aspects of Transfer Pricing
4. Explain the Importance of Transfer Pricing
5. Explain the objectives of Transfer Pricing

Main Content

Transfer price is, thus, a price which represents the value of good; or services between independently operating units of an organisation. But, the expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.

Transfer prices are the amounts charged during intercompany transactions between related companies. It is the price paid for goods or services that are transferred from one unit of an organisation to its other units in different states or countries. "Transfer pricing is the price determined for the transactions between two or more related entities within a multi-company organization. This price is also known as the cost of transfer which shows the value of such transfer between the related entities in terms of goods or even transfer of employees or labor across different departments.

"Transfer pricing is an accounting practice that represents the price that one division in a company charges another division for goods and services provided. Transfer pricing allows for the establishment of prices for the goods and services exchanged between subsidiaries, affiliates, or commonly controlled companies that are part of the same larger enterprise. Transfer pricing is a profit allocation method used to attribute a Multi-National Enterprises net income (profit or loss) to the tax jurisdictions where it operates its subsidiary controlled foreign corporations (CFCs). The

transfer price is defined as the price charged between related corporate entities for goods or services in an intercompany transaction.

Features of Transfer Pricing

Transfer pricing refers to the pricing of goods, services, or intangible assets exchanged between related parties, such as different divisions of the same company or entities within a multinational enterprise. It is a crucial aspect of international tax and financial management, ensuring that transactions between related parties are conducted at arm's length to prevent tax evasion and ensure fair profit allocation among various entities. The features are:

Arm's Length Principle (ALP): The fundamental principle of transfer pricing is to determine prices or charges for transactions between related parties as if they were conducted between independent, unrelated parties.

Comparability Analysis: This involves comparing the terms and conditions of related party transactions with those of transactions between independent parties to establish the arm's length price

Documentation and Compliance: Multinational enterprises are required to maintain comprehensive documentation supporting the arm's length nature of their transfer pricing arrangements, as per the regulations of the relevant tax jurisdictions.

Types of Transactions Covered: Transfer pricing covers various transactions, including the transfer of tangible goods, intangible assets, services, loans, financing, and royalty payments.

Methods of Determination: Common transfer pricing methods include the Comparable Uncontrolled Price (CUP) method, Cost Plus method, Resale Price method, Transactional Net Margin method (TNMM), and Profit Split method.

Functional Analysis: This involves analysing the functions, assets, and risks (FAR) of each related party involved in a transaction to determine their contribution and the allocation of profits or losses.

- **Advance Pricing Agreements (APAs)**: APAs are arrangements made between tax authorities and taxpayers, determining the appropriate transfer pricing methodology and acceptable range of prices in advance for a specific set of transactions.

• **Transfer Pricing Adjustments**: Tax authorities may adjust transfer prices if they determine that the prices or terms differ from what would have been agreed upon by unrelated parties, leading to tax consequences and potential penalties.

• **Country-by-Country Reporting (CbCR):** Multinational enterprises are required to provide detailed information on their global allocation of income, taxes paid, and other indicators of economic activity, enhancing transparency and compliance.

• **Risk Management and Controversies**: Managing transfer pricing risks involves proper planning, documentation, and defence strategies to address potential challenges or disputes with tax authorities.

Historical prospects of transfer pricing

History traces the first transfer pricing legislation to UK in 1915, with USA following suit in 1917. The main intention of the introduction of these provisions was to discourage companies to shift profit to overseas associate entities through under-pricing or over-pricing of cross border transactions. They had limited impact.

In the period after 1960, countries started laying emphasis on detailed rules to counter the devices for shifting profits from one legal jurisdiction to another with the object of reducing tax impact. The period of 1970's saw many developed countries trying to develop expertise in transfer pricing matters and applied prevailing law to deal with transactions routed through tax heavens when simpler or conventional provisions could not be made applicable. The Organisation for Economic Co-operation and Development (OECD) which was established in 1961 and now 34 countries are its members. OECD undertook an in depth analysis of transfer pricing provisions and published a report on "Transfer Pricing and Multinational Enterprises" in 1979. It prescribed three standard methods of computing Arms' Length Price (ALP) namely Comparable Controlled Price, Resale Price and Cost Plus and mentioned the danger of using other bases for determining ALP.

In 1984, OECD published its report which dealt with transfer pricing for intra group services and dealt with the treatment of intra-bank interest and other issues which could not be resolved under the tax treaties. The United Kingdom in 1984 introduced a new anti-avoidance legislation called "The Controlled Foreign Corporation (CFC) rules". These rules provided that profits accumulated in off shore subsidiaries should be attributed back to the parent company. But the provisions did

not include cases where off shore parent companies charged higher than ALP from their subsidiaries. OECD reports published in 1987, 1988 and 1994 dealt with the problems relating to thin capitalization, the tax consequences of foreign exchange gains and losses and attribution of income to Permanent Establishment (PE).

The OECD Guidelines, published in 1995 represents a consensus among OECD Member countries, mostly developed countries, and have largely been followed in domestic transfer pricing regulations. The first Indian attempt at Transfer Pricing Regulations was in 2001, when the Finance Act amended the Income Tax Act, 1961 by the amendment of Section 92 and insertion of new sections 92A to 92F providing for determination of proper income arising from international transactions where either or both the parties involved happen to be non-resident(s).

These provisions read with relevant rules 10A to 10T of the Income Tax Rules also stipulated the maintenance and keeping of information and documents by persons entering into an international transaction and furnishing report by an Accountant if the volume of transactions touches or crosses a prescribed threshold limit. 1.2.10 With effect from 1st April, 2013, the transfer pricing regulations were also extended to cover certain specified domestic transactions.

Importance of Transfer Pricing

Globalization: Advancement in technology (transportation, information and communication)has brought the distant parts of the world closer than before, National boundaries are fast disappearing as the flow of labour, capital, goods and services is no longer restricted to geographical factors, in consequence, goods, services and intangibles produced by entities of agroup in one country must be transferred to entities of same based in another country.

Specialization: Business entities are increasingly embracing the time-tested principle of division of labour, specialization and comparative advantage to set up facilities in parts of the world that offer them maximum yield on one unit of the factors of production, this has led to the development of the concept of shared services.

Mergers and Acquisition: Increasingly companies are foraying into other countries; buying up other companies, the cost of central administration or other transfers from one entity to another in a group must satisfy tax authorities in the respective countries and that is what transfer pricing seeks to achieve. Fair distribution: The critical importance of Transfer Pricing provisions is that

there will be an equal and fair distribution of resources between associated entities leading to non-discriminatory trade transactions. This provides opportunities for associated enterprises to transact business between them as the transactions are valued at market price; this will enhance the scope of business and have a positive impact on the group company as a whole due to internal profits generated by these associated entities.

Benefit to tax authorities: Also, it is useful for the tax authorities to determine the actual value of such transactions and estimate the profits derived from such transactions taking place between associate entities. Without transfer pricing provision, there would be a reduction or avoidance of tax by misleading authorities and transferring or reporting profits based on the limitation presented in tax provisions.

Methods of Transfer Pricing

1. Comparable Uncontrolled Price (CUP) Method: This method compares the price of a controlled transaction with the price of a similar transaction between unrelated parties. It's often considered the most reliable method if appropriate comparable data is available.

2. Resale Price Method (RPM): RPM involves calculating the arm's length price by applying a gross margin to the resale price of goods acquired from a related party. This method is commonly used in the distribution industry.

3. Cost Plus Method (CPM): CPM involves adding a markup to the costs of goods or services incurred by the selling affiliate. The markup represents the arm's length profit margin.

4. Profit Split Method: This method allocates profits in a manner that independent parties would agree upon. It's often used when contributions from each related party are interdependent, and determining a clear-cut comparable is difficult.

5. Transactional Net Margin Method (TNMM): TNMM compares the net profit margin of a controlled transaction to the net profit margin realized by unrelated parties engaged in similar transactions. It's based on operating profit relative to an appropriate base (e.g., sales, assets, or costs).

6. Transactional Profit Split Method: This method involves splitting the combined profits from a controlled transaction between related parties based on their relative contributions to generating those profits.

7. Comparable Profits Method (CPM): CPM compares the operating profits earned in a controlled transaction to the operating profits earned by comparable independent enterprises engaged in similar transactions.

8. Advanced Pricing Agreements (APAs): APAs are agreements between taxpayers and tax authorities that determine the transfer pricing methodology in advance for a set period. This provides certainty and helps in avoiding transfer pricing disputes.

9. Cost Sharing Arrangements (CSAs): CSAs allocate the costs and risks associated with developing intangible assets among related parties. They establish a framework for sharing future benefits from the exploitation of these assets.

10. Fixed or Formula-Based Methods: These methods use predetermined formulas or fixed rates to establish transfer prices based on historical data, industry benchmarks, or other established criteria.

Profit Split Method

The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

How the profit split method works?

In some cases, companies engage in transactions that are too interconnected to be observed on a separate basis. For example, two related companies might work together on a separate joint venture, such as developing and launching a new brand. As the PSM looks at the combined profits of two related parties entering into a transaction with one another, it can be used for determining

how profits will be divided in a way that is fair to both organizations. It can be applied in three different ways:

- The comparable profit split method,
- Contribution profit split method, and
- Residual profit split method.

Companies select an approach based on how the transaction is structured and the data available.

1. To apply the comparable profit split method, related companies must find a comparable transaction where two related parties' split profits, and then use it as a baseline for how their own profits should be divided.

2. The contribution profit split method is applied by looking at the relative financial or other contributions made by the two companies entering into a transaction. A fair profit split is then determined based on those contributions.

3. The residual profit split method looks at total profits, removes the profits made by the routine functions of both parties computed using the comparable profit method and residual profits are split, generally based on each party's investments and relative spending.

The PSM is most often applied by companies in complex industries with relatively high profits, such as high technology and pharmaceutical organizations. It's especially useful when dealing with intangible goods, such as intellectual property, as these transactions are often too complex for the other methods to be applied.

Methods to split the profits:

There are generally considered to be two specific methods to allocate the profits between the associated enterprises: contribution analysis and residual analysis.

Contribution analysis:

The combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions. External market data that reflect how independent

enterprises allocate the profits in similar circumstances should complement the analysis to the extent possible.

Residual analysis:

The residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangible property to the transaction. For example, Company X manufactures components using valuable intangible property and sells these components to a related Company Y which uses the components and also uses valuable intangible property to manufacture final products and sells them to customers. The first step of a residual analysis would allocate a basic (arm's length) return to Company X for its manufacturing function and a basic (arm's length) return to Company Y for its manufacturing and distribution functions.

The Residual Profit Split Method is used more in practice than the contribution approach for two reasons. Firstly, the residual approach breaks up a complicated transfer pricing problem into two manageable steps. The first step determines a basic return for routine functions based on comparable. The second step analyses return to often unique intangible assets based not on comparable but on relative value which is, in many cases, a practical solution. Secondly, potential conflict with the tax authorities is reduced by using the two- step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step

Strengths and Weaknesses of split the profits method:

Strengths:

¬ It is suitable for highly integrated operations for which a one-sided method may not be appropriate;

¬ It is suitable in cases where the traditional methods prove inappropriate due to a lack of comparable transactions;

¬ The method avoids an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e., all parties to the controlled transaction are being analysed); and

¬ This method is able (uniquely among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

Weaknesses:

¬ The profit split is more arbitrary and subjective in this method as compared to other methods and thus, the tax authorities would always prefer to have a closer look into the basis of arriving the same.

¬ Accounting policies may not be consistent amongst associated enterprises especially when they are located in different geographies resulting in difficulty to arrive at combined costs or revenue.

When to use the Profit Split Methods:

1. The Profit Split Method might be used in cases involving highly interrelated transactions that cannot be analysed on a separate basis. This means that the Profit Split Method can be applied in cases where the associated enterprises engage in several transactions that are so interdependent that they cannot be evaluated on a separate basis using a traditional transaction method. In other words, the transactions are so interrelated that it is impossible to identify comparable transactions. In this respect, the Profit Split Method is applicable in complex industries such as, for example, the global financial services business.

2. The (Residual) Profit Split Method is typically used in complex cases where both sides to the controlled transaction own valuable intangible property (e.g., patents, trademarks and trade names). If only one of the associated enterprises owns valuable intangible property, the other associated enterprise will be the tested party in an analysis using the cost plus, resale price or transactional net margin methods. However, if both sides own valuable intangible properties for which it is impossible to find comparable, then the Profit Split Method might be the most reliable method

3. The Profit Split Method involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor and calculating the allocation of profits between the associated enterprises.

Different Aspects of Transfer Pricing

The practice of transfer pricing involves several critical components:

1. Regulatory Compliance: Compliance with transfer pricing regulations is paramount. Different countries have their own rules and guidelines regarding transfer pricing, and multinational companies must comply with the specific regulations of each country they operate in.

2. Method Selection: Companies need to select appropriate transfer pricing methods based on the nature of the transaction and available data. Common methods include the Comparable Uncontrolled Price (CUP) method, Cost Plus method, Resale Price method, Profit Split method, and Transactional Net Margin Method (TNMM).

3. Comparability Analysis: This involves comparing the terms and conditions of transactions between related parties with transactions between unrelated parties to ensure they are consistent with the arm's length principle.

4. Documentation and Reporting: Detailed documentation is essential to substantiate the transfer pricing method chosen and demonstrate compliance with regulations. This documentation includes functional analysis, economic analysis, and comparability analysis.

5. Risk Assessment and Mitigation: Multinational corporations need to assess the risks associated with transfer pricing, including potential tax audits and disputes. Effective risk management strategies are vital to mitigate these risks.

6. Advance Pricing Agreements (APAs): APAs are agreements between taxpayers and tax authorities that establish a predetermined transfer pricing methodology, providing certainty and minimizing the risk of disputes.

7. Global Tax Planning: Multinational corporations strategically plan their transfer pricing policies to optimize their global tax position, considering tax implications and aligning transfer pricing with their overall business strategy.

8. Dispute Resolution and Controversies: Transfer pricing disputes may arise with tax authorities. Effective dispute resolution mechanisms, like Mutual Agreement Procedures (MAPs), are used to resolve conflicts and avoid double taxation.