INTERNATIONAL ACCOUNTING

M.Com. (Accountancy)

Semester – IV, Paper – I

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson- writers of the Centre who have helped in these endeavours.

Prof. Raja Sekhar Patteti
Vice-Chancellor
Acharya Nagarjuna University

M.Com (Accountancy)

Semester - IV

405CO21: International Accounting

SYLLABUS

UNIT – 1: INTERNATIONAL ACCOUNTING: AN OVERVIEW: Development of International Accounting- Scope of International Accounting. Importance of International Accounting.

UNIT - 2: FOREIGN CURRENCY TRASACTION AND TRANSLATION: Definition of Foreign Currency transaction and Translation, need for and issues involved in Foreign Currency Translation, Process of recording foreign (international) Transactions, Accounting Treatment of Forward Currency Translations, Techniques of Foreign Currency Translations, Treatment of Translation Gains and Losses.

UNIT – 3: ACCOUNTING FOR PRICE LEVEL CHANGES: Concepts and Forms of Price Level Changes- Types of Price Level Changes Common Phenomenon of Price Level Changes: Need for Price Level Changes Adjustments- Factors Causing Distortions to Accounting Profit vis-à-vis financial statements-

UNIT- 4: TRANSFER PRICING: Need for Transfer Pricing- Factors Governing Transfer Pricing Policy- Methods of Transfer Pricing- Transfer Pricing Methods- Comparison- Transfer Pricing Methods in practice- Fixing a minimum Transfer Pricing

UNIT- 5: SEGMENT REPORTING: International GAAP on Segment Reporting- Difference between Business, Geographical, Reportable Segment- Disclosure Requirements- Indian GAAP on Segment Reporting- Segment Reporting in Practice- Corporate Disclosure in Practice

INTERNATIONAL FINANCIAL REPORTING: Provision of International GAAP on Interim reporting-IAS 34 on Interim Financial Reporting- Disclosures in Interim Financial Reporting- Comparative statements

FURTHER READINGS:

1. A.K. Das Mohappatra, International Accounting, Prentice Hall of India, 2007.
2. Frederick D.S.Choi, Gary K. Meek, International Accounting, Pearson Education,2007
3. Shahrokh M. Saudagaran, International Accounting- A user Perspective, Thomson south, western.

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Lesson – 1

INTERNATIONAL ACCOUNTING – AN HISTORICAL PROSPECT

Learning objectives:

- ✓ To understand various stages of development of international accounting
- ✓ To get the knowledge about changes in international accounting
- ✓ To know the financial regulations covered by international accounting
- ✓ To able to understand the role of regulations on international accounting
- ✓ To understand the growth of accounting system

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1.0 Introduction:

International accounting has obviously developed in recent years, and this has influenced a wide range of research and publications on the subject. But there is a paradox; there is still no real definition of international accounting. This chapter is trying to explain the importance of international accounting and propose an approach to its definition.

International differences in accounting rules pose a substantive challenge to international companies, investors, creditors, governments, different users, who interested in making cross-border transactions and/or comparisons of financial statements and companies value. While current efforts to harmonize international standards are laudable, they are unlikely to completely eliminate cross- border accounting diversity.

International accounting is a branch focused on using specific accounting standards while balancing a company's books overseas. International accounting involves keeping track of the tax rules and accounting principles that can affect a business transaction or operation. International accounting has become an essential subset of accounting and business in the present century, given the spread and effectiveness of e-Commerce. Businesses are no longer limited to a region or country, which calls for convenience and encourages cross-border business partnerships.

International accountants provide accounting services to companies and businesses that operate in various countries or deal with businesses from around the world. Their role is even more critical when the respective financial markets employ different financial accounting guidelines, and the statements must be maintained accordingly.

1.1 Definition of international accounting:

The international accounting is the international aspects of accounting, including such matters as accounting principles and reporting practices in different countries and their classification; patterns of accounting development; international and regional harmonization, foreign currency translation; foreign exchange risk; international comparisons of consolidation accounting and inflation accounting; accounting in developing countries; accounting in communist countries; performance evaluation of foreign subsidiaries.

> "There is nothing new about international accounting, accounting has always been international, from the time it emerged some thousands of years ago, because of its concern with international trade and because of the spread of ideas across countries."

> "International accounting extends general-purpose nationally oriented accounting in its broadest sense to:
>
> a. International comparative analysis,
> b. Accounting measurement and reporting issues unique to multinational enterprises,
> c. Accounting needs of international financial markets.
> d. Harmonization of worldwide accounting and financial reporting is diversity via political, organizational, professional and standard-setting activities."

International accounting is 'that branch of accounting which analyses the different accounting principles and practices prevalent around the globe, deals with die specific technical problems encountered b) individuals and MNCs in international operations and as

its ultimate goal, attempts to develop a universal system of accounting that would receive acceptance the world over."

1.2 Historical evolution of international accounting:

Creation of international system of accounting was an objective process that was influenced by global economic development and was tightly connected to development of accounting as a science; formalization of theories of accounting and establishment of different schools of accounting and evolution of the entire economic profession. International system of accounting was envisioned as a solution to the problem of incompatibility of economic information across countries, economic entities and users of such information who are tasked with economic decision-making. Accounting, as the international language of business, should insure that information that is formed both on the level of individual business entities and economy as a whole is understandable, correct, sufficient and compatible.

Historical aspects of development of accounting have been studied extensively by many academic researches. However, development of the international system of accounting has not been considered in a holistic way that would emphasize various stages of development and consider distinct factors that influenced accounting at those stages.

According to F. F. Butynets:

> "A system of accounting is not just a collection of interconnected elements but also a system that is interconnected with an environment within which it exists. That's why when analyzing origins of international accounting, most researchers consider them within the context of the history of development of accounting"

Different stages of international accounting development may consider in five main stages:

1. Trade stage: Until 1800,
2. Entrepreneurial stage – up to 1900,
3. Organizational stage – until 1950,
4. Optimization stage – between 1950 and 1975, and
5. Strategic stage – since 1975.

1.2.1 Trade Stage (until 1800 A.D.):

Prior to 1800 AD, international accounting was in its infancy. Basic accounting methods were used in various civilizations, and double-entry bookkeeping was introduced in the Roman era. The Renaissance period brought advancements in accounting techniques, but standardized international accounting practices as we know them today did not emerge until much later. The development of international accounting standards and professional bodies would come in the following centuries as global trade continued to grow.

International accounting, as we understand it today, had limited formalization prior to 1800 AD. However, there were rudimentary forms of trade and accounting practices that laid the foundation for later developments. Here's a brief history of international accounting before 1800 AD:

a. Ancient Civilizations (3000 BC - 500 AD):

i. The earliest records of accounting can be traced back to ancient civilizations like Mesopotamia, Egypt, and Greece. These early societies engaged in trade and used basic accounting methods to record transactions and track their financial activities.

ii. In Mesopotamia, clay tablets dating back to around 3000 BC contain records of transactions, which can be considered early forms of accounting.

b. Roman Empire (1st century BC - 5th century AD):

i. The Romans played a significant role in the development of accounting. They introduced the concept of double-entry bookkeeping, which involves recording both debits and credits to maintain a balance of financial transactions.

ii. Roman accountants used abaci (calculating boards) and codified accounting methods to manage the finances of the empire, including taxation and trade.

c. Medieval Europe (5th century - 15th century AD):

i. During the middle Ages, trade routes expanded, and merchants engaged in international trade. However, accounting practices remained relatively simple and were often informal.

ii. Monasteries played a key role in preserving accounting knowledge, and some manuscripts from this era include accounting-related content.

d. Renaissance (14th century - 17th century AD):

i. The Renaissance period saw a resurgence of interest in mathematics and accounting. Luca Pacioli, an Italian mathematician and Franciscan friar, published his work "Summa de Arithmetica, Geometria, Proportioni et Proportionalita" in 1494, which included detailed instructions on double-entry bookkeeping.

ii. Pacioli's book became widely influential and is considered the foundation of modern accounting principles.

a. Emergence of International Trade:

i. As global trade routes expanded, the need for standardized accounting practices across borders became evident. However, formal international accounting standards did not yet exist.

b. The East India Company (17th century):

i. The British East India Company, established in the early 17th century, conducted significant international trade operations. It employed accountants and developed accounting practices to manage its overseas business ventures.

Prior to 1800 AD, international accounting was in its infancy. Basic accounting methods were used in various civilizations, and double-entry bookkeeping was introduced in the Roman era. The Renaissance period brought advancements in accounting techniques, but standardized international accounting practices as we know them today did not emerge until much later. The development of international accounting standards and professional bodies would come in the following centuries as global trade continued to grow.

At the end of Nineteenth century and beginning of Twentieth century's, several countries passed Laws that created a legal accounting framework. At the same time, several professional accounting associations have been created which later had a significant impact on establishment of an international system of accounting. Such associations include Institute of Accountants in Edinburgh and Glasgow (created in 1853), Society of Accountants in Aberdeen (1867), and Manchester Institute of Accountants (1887), Scottish Institute of Accountants (1880), American Association of Public Accountants (1887), Canadian Institute of Chartered Accountants (1902), London Association of Accountants (1904) etc.

1.2.2 Growth of international accounting during the early of this century:

In 1904 the first International Congress of Accountants took place in St. Louis, Missouri (USA). At the congress were represented not only American accountants but also accountants from England, Scotland, Netherlands and Canada. This congress can be considered as a first significant event in establishing an international system of accounting. The main issues discussed at the congress were consolidation of accounting profession, growth of world economy, development of auditing firms, establishment of standards for calculating corporate profits (Dennis, 2004). During the congress, participants considered which accounting services are necessary for end users and what needs to be done to satisfy the needs of the users of accounting information.

At this congress international aspects of accounting where not addressed directly, it laid the groundwork for productive discussion in this area. This was evidenced by the next congress which took place in 1926 in Amsterdam, where 370 attendees represented 15 countries. The goal of the congress was to share knowledge, experiences and methodologies from different countries, to seek universal treatment of cost accounting that would be acceptable internationally. At this congress, materials were translated into English, French and German. Most questions raised at the congress were closely tied to global economic development and internationalization. At this congress there was even a proposal to create an international prize similar to Nobel Prize for advances in accounting.

It was around this time when the first transnational corporation became reality. They were primarily focused on extraction of natural resources from colonial countries in Asia, Africa and Latin America and processing those resources at the facilities based in the colonizer countries.

The next important milestone in development of international system of accounting was a stock market crash of 1929 which led to subsequent global depression in developed countries. This crash exposed deficiencies in existing systems of accounting and financial reporting. There were deep differences in principles of financial reporting across countries and even across companies within the same country. Reporting was not always perceived correctly by the users of accounting information. Information was not suitable for analysis of economic entities and led to erroneous and conflicting conclusions about business activities and financial conditions of companies. It is notes that it was the financial crisis in USA that

led to creation of nationally recognized standards of accounting and reporting which were adopted by corporations whose stocks were traded on exchanges.

At the beginning of 20th century, it became clear that traditional accounting did not keep up with the needs of management in an increasingly competitive environment, rapidly changing technology and growing complexity of organization of production. Therefore, the first stage of development of international system of accounting was marked by creation of a legal framework for accounting in some countries, establishment of professional accounting associations, rethinking of the role of accounting.

1.2.3 International account and great depression:

The Great Depression of 1929, which started at USA and spread throughout the world, was a catastrophic event in world history that had far-reaching implications for various aspects of society, including the field of international accounting. This The significant changes in international accounting that were prompted by the Great Depression, highlighting the key factors that drove these transformations and their lasting impact on the discipline.

The Pre-Depression Accounting Landscape: Before delving into the changes brought about by the Great Depression, it is essential to understand the state of international accounting during the pre-Depression era. Accounting practices varied widely across countries, and there was no standardized framework for financial reporting or auditing. This lack of uniformity hindered international trade and investment and made it difficult for investors to assess the financial health of foreign companies.

1.3 Factors Driving the Change:

1.3.1 Economic Turmoil: The economic turmoil of the 1929 Great Depression was a profound and devastating global economic crisis that had far-reaching consequences. That impact was clearly shown on the accounting systems which followed in those days. Here is a brief overview of the economic turmoil during this period:

- **Stock Market Crash:** The Great Depression began with the stock market crash of October 29, 1929, commonly known as Black Tuesday. Stock prices plummeted, wiping out vast amounts of wealth, and triggering a panic among investors.

- **Bank Failures:** The stock market crash led to a wave of bank failures as people rushed to withdraw their savings. Many banks were unable to meet the demands for cash, exacerbating the financial crisis.

- **Collapse of Consumer Spending:** With the loss of savings and declining consumer confidence, people sharply reduced their spending. This drop in consumer demand had a cascading effect on businesses, leading to layoffs and reduced production.

- **Decline in International Trade:** The Great Depression was not limited to the United States; it had a global impact. International trade contracted significantly as countries imposed protectionist measures, including tariffs, in a bid to shield their domestic industries.

- **Deflation:** Prices fell across the board due to reduced consumer demand and excess production capacity. Deflation, or falling prices, made it difficult for businesses to repay debts and recover financially.

- **Unemployment:** Unemployment rates soared as companies laid off workers and businesses shut down. Joblessness reached unprecedented levels, with millions of people out of work and struggling to make ends meet.

- **Agricultural Crisis:** The agricultural sector suffered from falling commodity prices and droughts, leading to widespread rural poverty and farm foreclosures.

- **Government Interventions:** In response to the crisis, governments around the world implemented various intervention measures, including public works projects, financial sector reforms, and social programs, to try to alleviate the suffering and stimulate economic recovery.

- **Dust Bowl:** In the United States, a severe environmental crisis known as the Dust Bowl exacerbated the economic turmoil. A combination of drought and poor farming practices resulted in massive dust storms that damaged crops and livelihoods in the Great Plains.

- **Long-lasting Effects:** The Great Depression had a profound and lasting impact on the global economy. It fundamentally reshaped economic policies and led to the establishment of social safety nets to prevent such a crisis from happening again.

The 1929 stock market crash led to a severe economic downturn that affected businesses worldwide. The resulting financial distress and bankruptcies exposed shortcomings in accounting practices, particularly in the United States. Governments and investors demanded greater transparency and reliability in financial reporting to restore confidence in the financial markets.

1.3.2 Increased Cross-Border Investments:

Increased cross-border investments in the light of the Great Depression of 1929 were influenced by several factors, both before and during the crisis. Here's a brief overview of the dynamics surrounding increased cross-border investments during this period:

- **Globalization and Economic Growth Pre-1929:** In the decades leading up to the Great Depression, the world experienced a period of globalization characterized by increased trade, investment, and economic interdependence. Advances in transportation and communication facilitated international business activities, leading to a surge in cross-border investments.

- **Investor appetite for Diversification:** Investors sought to diversify their portfolios to spread risk and enhance returns. This drove them to explore investment opportunities in foreign markets.

- **Foreign Direct Investment (FDI):** Multinational corporations, particularly those based in industrialized countries like the United States, were expanding their operations abroad. They established subsidiaries and invested in foreign enterprises to tap into new markets and resources.

- **Attractive Foreign Markets:** Certain foreign markets, such as Europe, appeared attractive for investment due to their economic growth and potential for high returns.

- **Speculation and Stock Market Bubbles**: The stock market boom of the 1920s saw speculative investments in stocks, including those of foreign companies. Investors sought quick profits through trading in international securities.

- **Currency Speculation:** Currency speculation was prevalent during this period. Investors speculated on foreign exchange rates, seeking to profit from fluctuations in currency values.

- **Global Financial Interconnectedness:** The international financial system was becoming increasingly interconnected. Banks, financial institutions, and stock markets had ties to foreign counterparts, making cross-border investments more accessible.

1.3.2 The Great Depression hit:

- **Stock Market Crash and Economic Collapse:** The 1929 stock market crash shattered investor confidence and led to a severe economic downturn. Many investors faced massive losses.

- **Bank Failures:** The banking crisis that followed the crash further eroded trust in the financial system, affecting cross-border investments as investors withdrew their funds.

- **Protectionist Measures:** Many countries, in an attempt to protect their domestic industries and economies, imposed tariffs and other protectionist measures. This hindered international trade and investment.

- **Repatriation of Capital:** In response to the crisis, investors and multinational corporations often repatriated their capital from foreign markets to address financial difficulties at home.

- **Currency Devaluations:** Currency devaluations and exchange rate fluctuations negatively impacted the value of foreign investments, leading to substantial losses for investors.

Hence, it is concluded that the period leading up to the Great Depression witnessed increased cross-border investments driven by globalization, diversification, attractive foreign markets, and speculation. However, the crash and the subsequent economic turmoil resulted in a reversal of these trends. Protectionism, economic instability, and the collapse of financial institutions led to a decline in cross-border investments during the Great Depression, underlining the interconnectedness of the global economy and its vulnerability to economic crises. This leads to concentrate on the new era of accounting system which accepted by the entire world.

1.4 Role of Regulators:

The role of regulators during the Great Depression of 1929 was pivotal in responding to the economic crisis, restoring confidence in financial markets, and implementing reforms to prevent future disasters. Here is a brief overview of the role of regulators during this period:

1.4.1 Creation of Regulatory Frameworks:

In the aftermath of the stock market crash in 1929, the U.S. government recognized the need for comprehensive regulatory measures to stabilize the financial system. The Securities Act of 1933 was enacted to regulate the issuance of securities and ensure that investors received accurate and transparent information about investments. The Securities Exchange Act of 1934 established the Securities and Exchange Commission (SEC) to oversee and regulate securities markets, exchanges, and broker-dealers. The SEC became a crucial regulatory authority responsible for enforcing securities laws.

1.4.2 Market Surveillance and Investor Protection:

The SEC was tasked with monitoring stock and securities markets, ensuring fair trading practices, and protecting investors from fraudulent and manipulative activities. Regulators like the SEC played a crucial role in investigating and prosecuting those responsible for fraudulent activities and insider trading that contributed to the market crash.

1.4.3 Standardization of Accounting and Reporting:

Regulators recognized the importance of standardizing accounting and reporting practices to enhance transparency and comparability of financial information. The SEC worked closely with the accounting profession to develop Generally Accepted Accounting Principles (GAAP), which became the foundation for consistent financial reporting in the United States.

1.4.4 Prevention of Stock Manipulation:

Regulators implemented rules and regulations to prevent stock market manipulation, curb excessive speculation, and protect against fraudulent trading practices that had contributed to the crash. The creation of margin requirements and restrictions on short selling were some of the measures introduced to stabilize stock markets.

1.4.5 Banking Sector Reforms:

Regulators, including the Federal Reserve, worked to stabilize the banking sector by implementing measures such as deposit insurance (through the establishment of the Federal Deposit Insurance Corporation or FDIC) to restore confidence in the nation's banks. Banking regulations were strengthened to prevent bank failures and ensure the stability of the financial system.

1.4.6 Public Confidence Restoration:

Regulators played a crucial role in rebuilding public trust in financial institutions and markets through transparency and accountability measures. They actively communicated with the public to provide assurance that steps were being taken to address the economic crisis.

1.5 New Deal Initiatives:

The government under President Franklin D. Roosevelt introduced a series of New Deal initiatives, including the establishment of regulatory agencies such as the SEC and the FDIC, to address the root causes of the Depression and stimulate economic recovery.

Regulators played a vital role during the Great Depression by creating regulatory frameworks, overseeing financial markets, protecting investors, standardizing accounting practices, preventing stock manipulation, and implementing banking sector reforms. Their actions were instrumental in stabilizing the financial system, restoring confidence in the

markets, and setting the stage for financial market regulation that continues to shape the financial industry to this day.

1.6 Changes in International Accounting:

The following are some identical changes are noticed during the period of great depression:

1.6.1 Standardization:

The Great Depression spurred efforts to standardize accounting principles and practices. In the United States, the American Institute of Accountants (now the American Institute of CPAs) and the Securities and Exchange Commission (SEC) played a pivotal role in developing Generally Accepted Accounting Principles (GAAP).

1.6.2 Increased Disclosure:

In response to the demands for transparency, financial reporting standards were revamped to require more detailed disclosures of financial information, including income statements, balance sheets, and cash flow statements.

1.6.3 Auditing and Accountability:

The Great Depression highlighted the importance of independent auditing to verify the accuracy of financial statements. As a result, auditing standards were strengthened to ensure the integrity of financial reporting.

1.6.4 International Cooperation:

The Depression era marked the beginning of international cooperation in accounting. Organizations like the International Federation of Accountants (IFAC) were established to promote consistency in accounting practices across borders.

1.6.5 Lasting Impact:

The changes initiated during the Great Depression laid the groundwork for modern international accounting standards. The development of International Financial Reporting Standards (IFRS) by the International Accounting Standards Board (IASB) reflects the global convergence of accounting standards that began in the aftermath of the Great Depression. The lasting impact of the Great Depression of 1929 was profound and far-reaching, influencing economic policies, government interventions, and financial regulations for decades to come. Here is a brief overview of the lasting impact of the Great Depression:

1.7 Financial Regulations and Reforms:

The Great Depression led to the establishment of a comprehensive regulatory framework to oversee financial markets and institutions. This included the creation of the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) in the United States. These regulatory bodies aimed to prevent fraud, ensure transparency, and protect investors and depositors. The regulatory framework laid the foundation for modern financial market oversight.

1.7.1 Social Safety Nets:

The suffering and social unrest caused by the Great Depression prompted governments to introduce social safety nets. Programs like Social Security in the United States provided financial support for the elderly and vulnerable citizens, reducing poverty rates.

1.7.2 Keynesian Economics:

The Depression also had a profound impact on economic thought. The ideas of British economist John Maynard Keynes gained prominence. Keynesian economics advocated for government intervention in the economy, including fiscal policies like deficit spending during economic downturns to stimulate demand.

1.7.3 Monetary Policy:

The Great Depression led to a reevaluation of monetary policy. Central banks, such as the Federal Reserve, adopted policies to maintain stable prices and prevent severe deflation, a lesson learned from the deflationary spiral of the 1930s.

1.7.4 International Cooperation:

The global nature of the Great Depression highlighted the need for international cooperation. The Bretton Woods Conference in 1944 established a new international monetary system and led to the creation of the International Monetary Fund (IMF) and the World Bank, promoting global financial stability.

1.7.5 Depression-Era Memories:

The enduring memories of the Great Depression influenced subsequent generations, fostering a culture of savings, frugality, and risk aversion. These lessons influenced investment behavior, household financial planning, and the perception of financial security.

1.7.6 Diversification and Risk Management:

Investors and financial institutions learned the importance of diversifying investments and managing risk to prevent catastrophic losses. Concepts of risk management and portfolio diversification became integral to investment strategies.

1.7.7 Historical Precedent:

The Great Depression serves as a historical precedent and a stark reminder of the catastrophic consequences of economic mismanagement and financial excesses. Policymakers, economists, and financial institutions have continuously studied and analyzed the Great Depression to prevent a similar crisis.

The Great Depression of 1929 triggered a seismic shift in international accounting. The economic turmoil, increased cross-border investments, and regulatory responses of that era compelled nations to adopt more standardized and transparent accounting practices. These changes, driven by the need for stability and accountability, continue to shape the field of international accounting, emphasizing the importance of consistent standards, transparency, and cooperation in today's interconnected global economy.

1.8 Summary:

International accounting is a branch which focused on using specific accounting standards while balancing a company’s books overseas. It involves keeping track of the tax rules and accounting principles that can affect a business transaction or operation at international level. International accounting has become an essential subset of accounting and business in the present century, given the spread and effectiveness of e-Commerce. Businesses are no longer limited to a region or country, which calls for convenience and encourages cross-border business partnerships. To knowing the historical prospects of the

development of the international accounting system provides vast knowledge on the subject.

1.9 Key words:

Economic depression: A depression is a severe and prolonged downturn in economic activity. A depression may be defined as an extreme recession that lasts three or more years or which leads to a decline in real gross domestic product (GDP) of at least 10% in a given year. Depressions are far less common than milder recessions. Both tend to be accompanied by relatively high unemployment and relatively low inflation.

Dust bowl: The Dust bowl was the result of a period of severe dust storms that greatly damaged the ecology and agriculture of the American and Canadian prairies during the 1930s. The phenomenon was caused by a combination of natural factors (severe droughts) and man-made factors: a failure to apply dry land farming methods to prevent wind erosion, most notably the destruction of the natural topsoil by settlers in the region.

FDI: Foreign direct investment (FDI) is a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy. Ownership of 10 percent or more of the voting power in an enterprise in one economy by an investor in another economy is evidence of such a relationship. FDI is a key element in international economic integration because it creates stable and long-lasting links between economies. FDI is an important channel for the transfer of technology between countries, promotes international trade through access to foreign markets, and can be an important vehicle for economic development.

Speculation: Speculation (also known as speculative trading) is a financial term that refers to the act of purchasing an asset (a commodity, good or real estate) that has a substantial risk of losing value but also holds the hope of gaining value in the near future. An investor who's into speculative trading purchases an asset in an attempt to gain profit from small fluctuations in the market. These are high-risk, high gain investments that are made for a short amount of time and once the investor gets the desired profit, the investment is sold. For example- An investor who invests in foreign currency buys some currency in the hopes of selling it at an appreciated rate when market fluctuations happen. This type of speculation is known as currency speculation.

Devaluation: Devaluation is the deliberate downward adjustment of the value of a country's money relative to another currency or standard. It is a monetary policy tool used by countries with a fixed exchange rate or semi-fixed exchange rate.

Bretton woods agreement: The Bretton Woods Agreement was negotiated in July 1944 by delegates from 44 countries at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire. Thus, the name "Bretton Woods Agreement. Under the Bretton Woods System, gold was the basis for the U.S. dollar and other currencies were pegged to the U.S. dollar's value. The Bretton Woods System effectively came to an end in the early 1970s when President Richard M. Nixon announced that the U.S. would no longer exchange gold for U.S. currency

1.10 Self – assessment questions:

1 What is international accounting? Write its features.
2 How international accounting treated in ancient civilization?
3 What factors driving the change in great depression?
4 What are the changes occurring in international accounting after depression?
5 What are the financial regulations taken place after depression?

1.11 Further readings:

1. Author: Fred D. S. Choi and Gary K. Meek Title: International Accounting Publisher: Pearson
2. Author: Warren J. Samuels and K. Ramachandran Title: International Accounting: A User Perspective Publisher: Cengage Learning
3. Author: Timothy S. Doupnik and Hector Perera Title: International Accounting Publisher: McGraw-Hill Education
4. Author: Choi, Frederick D.S. and Agnes L. DeFranco Title: International Accounting, Global Edition Publisher: Pearson
5. Author: Christopher Nobes and Robert Parker Title: Comparative International Accounting Publisher: Prentice Hall
6. Author: Radebaugh, Lee H., Gray, Sidney J., and Ervin L. Black Title: International Accounting and Multinational Enterprises Publisher: Wiley
7. Author: Sidney J. Gray and Stephen P. Zeff Title: Financial Accounting Theory and Analysis: Text and Cases Publisher: Cengage Learning
8. Author: Sidney J. Gray and Lee H. Radebaugh Title: International Accounting and Multinational Enterprises Publisher: Wiley
9. Author: Frederick D. Choi, Gary K. Meek, and R. Dan Cottrell Title: International Accounting: A User Perspective Publisher: Pearson
10. Author: Christopher Nobes and Robert Parker Title: International Financial Accounting: A Comparative Approach Publisher: Pearson

Dr. Krishna Banana

Lesson - 2

INTERNATIONAL ACCOUNTING IN MODERN ERA

Learning objectives:

- ✓ To understand the drawbacks of traditional accounting system
- ✓ To know the historical prospects of international accounting
- ✓ To understand the operations of IASC
- ✓ To understand the innovations in international accounting
- ✓ To understand the technology impact on international accounting

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  2.7.3 Accounting Software
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  2.8.1 Online Collaboration and Remote Workforce
  2.8.2 Evolution of the Accountant Role
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  2.8.4 Changes in Tax Policy
  2.8.5 Statutory and Regulatory Compliance
  2.8.6 Environmental, Social and Corporate Governance (ESG)
  2.8.7 Accounting Standards

2.8.8 Proactive Accounting
2.8.9 Outsourcing
2.9 Summary
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2.0 Introduction:

At the beginning of 20th century, it became clear that traditional accounting did not keep up with the needs of management in an increasingly competitive environment, rapidly changing technology and growing complexity of organization of production.

2.1 Weaknesses of traditional international accounting system:

Traditional international accounting systems had several weaknesses that prompted the need for changes and reforms. These weaknesses include:

2.1.1 Lack of Uniformity:

Traditional international accounting systems were characterized by significant variations in accounting standards and practices across different countries. This lack of uniformity made it challenging for investors, analysts, and multinational corporations to compare financial statements and make informed decisions.

2.1.2 Complexity:

Traditional international accounting systems often relied on complex rules and principles that were difficult to understand and apply consistently. This complexity led to confusion and increased compliance costs for businesses.

2.1.3 Inadequate Transparency:

Traditional accounting systems sometimes lacked transparency, making it difficult for stakeholders to fully understand a company's financial position and performance. This lack of transparency could lead to mistrust and uncertainty in the financial markets.

2.1.4 Limited Relevance:

Traditional accounting standards often struggled to keep pace with rapidly evolving business practices and financial instruments. This limitation made it difficult to provide relevant and timely information to users of financial statements.

2.1.5 Inconsistencies in Reporting:

Differences in accounting standards and practices across countries led to inconsistencies in financial reporting. Companies could use these differences to their advantage by choosing accounting methods that presented their financial results in the most favorable light.

2.1.6 Lack of Convergence:

Traditional international accounting systems lacked a common set of global accounting standards, which hindered efforts to harmonize accounting practices worldwide. This lack of convergence made it challenging for multinational companies to prepare consolidated financial statements and meet the needs of global investors.

2.1.7 Incomplete Coverage:

Traditional accounting standards sometimes failed to address emerging issues or did not provide guidance for certain types of transactions and financial instruments. This gap in coverage created uncertainty and the potential for misclassification of items on financial statements.

2.1.8 Delayed Updates:

Updating traditional accounting standards often took a long time due to bureaucratic processes and international negotiations. This delay meant that accounting standards could become outdated and less relevant in a rapidly changing business environment.

2.2 Adoption of International Financial Reporting Standards (IFRS):

To address these weaknesses, there has been a push toward the adoption of International Financial Reporting Standards (IFRS) as a more modern and globally accepted accounting framework. IFRS aims to improve transparency, comparability, and relevance in financial reporting by providing a common set of accounting standards that can be used by companies across the world. While the transition to IFRS has made significant strides, challenges and variations still exist in its adoption and implementation in different countries. Nonetheless, the move toward a more standardized and globally accepted accounting framework reflects the recognition of the shortcomings of traditional international accounting systems. Development of the new international accounting is divided into three major stages, these are:

2.2.1 First stage:

End of 19th century or at the beginning of 20th century until the middle of 20th century. This stage is characterized by inception of the idea of having an internationally accepted set of accounting standards, adoption of legislation in various countries codifying their accounting principles, emergence of professional accounting associations, rethinking of the role of accounting in the system of management, and internationalization of information exchange among accounting professionals.

2.2.2 Second stage:

From the middle of the 20th century until the end of 20th century, international system of accounting begins to take shape. During this period appear first international accounting standards, and the process of harmonization of accounting systems across countries begins. Two international bodies – IASC and IFA are formed, and their activity is gradually recognized and supported by major international institutions.

2.2.3 Third stage:

From the end of 20th century, until present day, the efforts to harmonize accounting systems evolved into a broader concept of international convergence. International accounting standards are official accepted in many countries and a larger portion of global economy moves toward using IFRS. International system of accounting moves toward becoming a global system of accounting.

It is tried to explain the step-by-step development in the following:

2.3 Development in stage – I:

The first stage of development of international system of accounting was marked by creation of a legal framework for accounting in some countries, establishment of professional accounting associations, rethinking of the role of accounting. Interest in international system

of accounting grew toward the end of 1950s due to the fact that following the end of World War II there was increasing global economic integration which also led to increase in capital flows, international trade and foreign direct investment. Since the middle of the 20th century, due to expansion of international economic relationships, specialization and cooperation of production, creation of transnational corporations, the problem of incompatibility of accounting and auditing standards became of paramount importance

During this time, Europe started its movement toward unification. In 1951, European Coal and Steel Community (ECSC) was created, in 1957 European Economic Community (EEC) and European Atomic Entergy community are established (Euratom), and in 1960 European Free Trade Association is formed. During the 1960s, there was period of international mergers and acquisitions, particularly between American and European companies. In April of 1963, Business Week carried out a study on new form of business organization which was named «Multinational Corporation». Such international trends strengthened the need for a meaningful comparison of financial reporting that originated in different countries

2.4 Development in stage – II:

The middle of 20th century could be considered the second stage of development of international system of accounting.

In 1962, under the aegis of American Institute of Certified Public Accountants (AICPA), the 8th International Congress of accountants took place in New York. The central issue in the discussions that took place was the impact of global economy on accounting. Many participants of the congress stressed the urgency to make progress toward development of auditing and accounting practices as well as reporting standards on international level.

In the same year, AICPA established its own committee on international relations whose aim was to create programs for improving international cooperation between accountants of different countries and fostering exchange of information and ideas. In 1964 the committee published a survey of accounting standards of 25 countries (Professional Accounting in 25 Countries) that is considered to be the first attempt to research accounting, auditing and reporting standards on international level.

An important step in development of international system of accounting took place in 1966 when Henry Benson, a senior partner at a British accounting firm Cooper Brothers & Co. (later Cooper and Lybrand and currently Price Waterhouse Coopers) who served at the time as a president of Institute of Chartered Accountants of England and Wales, visited United States and Canada. He and the presidents of AICPA and Canadian Institute of Chartered Accountants reached an agreement to create Accountants International Study Group (AISG) that would study accounting and audit in these countries.

AISG took shape in 1966–1967 when representatives of professional accounting associations from Canada, United Kingdom and United States joined forces in attempt to harmonize accounting and auditing practices and form a long-term strategy for creating a set of international accounting standards. AISG functioned for ten years and published twenty guidelines before ceasing its existence in 1977. Studies conducted by AISG further highlighted difference in accounting practices between these three countries and, naturally, lack of consistency in reporting standards on a global level.

In 1967, was published the first textbook on international accounting that was written by Gerhard G. Mueller. His biographer, Dale L. Flesher, considers Mueller to be the father of international accounting and claims that it was Mueller who, through his academic work, spurred development of international accounting as a research field, and his impact was felt in both among theorists and practitioners. Muller was the first professor to offer international accounting as a field in a graduate school. He prompted development of research in international accounting in two directions:

1. He focused on importance of differences among international accounting and their significance for accounting profession and businesses who take part in international trade;

2. He emphasized importance of learning about differences in how accounting is taught in different educational institutions

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

On 7th October, 1977, at the 11th International Congress of Accountants in Munich, the International Federation of Accountants was founded. This organization was created with the aim of strengthening of accounting profession in the world in the interest of society. The organization was responsible for creation of high-quality international standards of auditing and accounting of private and government sector, development and implementation of ethics and education for professional accountants, fostering cooperation among members and with other international organizations, serving as international representative of accounting profession.

An important event in the second stage of development of international system of accounting was creation of two organizations:

a. International Accounting Standards Committee and
b. International Federation of Accountants.

2.5 Development in stage – III:

Even the formation of international accounting standerd committee is happened during the end of 1960s, the real function has happened after seventh century. The establishment and growth of the standards are considered as third stage in the development:

2.6 Formation, Organization and role of IASC:

2.6.1 Formation of IASC:

The International Accounting Standards Committee (IASC) was founded in June 1973 in London at the initiative of Sri Henry Benson, former president of the Institute of Chartered

Accountants in England and Wales. The IASC was created by national accountancy bodies from a number of countries with a view to harmonizing the international diversity of company reporting practices. Between its founding in 1973 and its dissolution in 2001, it developed a set of International Accounting Standards (IAS) that gradually acquired a degree of acceptance in countries around the world. Although the IASC came to include some organizations representing preparers and users of financial statements, it largely remained an initiative of the accountancy profession. On 1 April 2001, it was replaced by the International Accounting Standards Board (IASB), an independent standard-setting body. The IASB adopted the extant corpus of IAS which it continued to develop as International Financial Reporting Standards.

2.6.2 Membership of IASC:

The IASC was founded as a result of an agreement between accountancy bodies in the following countries.

- Australia, Institute of Chartered Accountants in Australia (ICAA) and the CPA Australia (formerly known as Australian Society of Certified Practicing Accountants (ASCPA)

- Canada (Canadian Institute of Chartered Accounts (CICA).

- France (Order des Experts Compatibles et des Compatibles Agrees (Order of Accounting Experts and Qualified Accountants).

- Germany (Institut der Wirtschaftsprufer in Deutschland (IDW) (Institute of Auditors in Germany) and the Wirtschaftsprüferkammer (WPK) (Chamber of Auditors).

- Japan Nihon Kouninkaikeishi Kyoukai (Japanese Institute of Certified Public Accountants, JICPA).

- Mexico Instituto Mexicano de Contadores Publicos (IMCP) (Mexican Institute of Public Accountants)) (removed from the board in 1987 due to non-payment of dues; resumed in 1995).

- The Netherlands (Nederlands Instituut van Registeraccountants (NIVRA) (Netherlands Institute of Registered Auditors).

- The Unite Kingdom and Ireland (counted as one)

- The United States of America (American Institute of Certified Public Accounts) (AICPA).

2.6.3 Organization of IASC:

At the core of the IASC was the committee, or board, consisting of delegations from the member bodies. The board typically met three to four times a year for two or three days in locations around the world. It was served by a permanent secretariat based in London. The technical agenda of the board was prepared by working groups known as steering committees, each appointed to develop proposals for a new or modified standard on a specific topic. Steering committee membership was on an individual, not institutional, basis, but appointment was based on recommendation by an IASC member body, industry organization or similar grouping.

From the start, the IASC adopted the practice of issuing draft standards (exposure drafts) for public comment before agreeing on a final standard. This allowed a degree of wider participation in the standard-setting work even though in practice a large proportion of the responses came from accountancy bodies, audit firms and national accounting standard setters. In 1981, the IASC established a Consultative Group, with a view to engaging a broader set of organizations in its work.

In 1996, the IASC set up a Standing Interpretations Committee (SIC), charged with issuing interpretations of standards on relatively narrow issues arising in practice.

2.6.4 Impact of IASC:

According to the IASC's Constitution, the member bodies were committed to use their 'best endeavors' with reporting companies, their auditors, governments and securities market regulators to ensure that published financial statements complied with IAS, and that audit reports referred to any non-compliance. In the absence of large-scale global surveys of corporate reporting practices for the 1970s and 1980s, it is not possible to assess with any degree of precision to what degree reporting companies adopted IAS. In the early 1980s, a number of Canadian listed companies began to assert compliance with IAS in their financial statements, but this seems to have been the case in few other countries. One explanation of this limited direct impact is that in most countries, national accountancy bodies had no authority to force companies to adopt IAS. This does not rule out an indirect influence of IAS, as national accounting standards in a range of countries incorporated elements of the national standards in national requirements.

The efforts of the IASC, from 1987 onwards, to improve its standards in order to make them an acceptable basis for cross-border listings led to greater recognition. During the 1990s, a number of major European companies began to prepare financial statements on the basis of US GAAP because of actual or planned listings in the United States. Others adopted IAS which was increasingly seen as a set of standards of sufficient quality for international capital markets. In 1998, German companies were allowed to satisfy their legal reporting requirements in Germany by publishing consolidated financial statements based on 'internationally recognized principles of accounting', which in practice meant either US GAAP or IAS.

These two organizations had similar yet different goals: While IASC Was responsible for developing standards for accounting and reporting, IFAC functioned as a global organization of accounting profession and dealt with problems of accounting and audit. Following creation of these two organizations, development of international accounting was focused on development of international standards and their gradual implementation marked by further recognition of IASC and IFAC as the primary global institutions of account professions that were in close cooperation with other leading global organizations.

In 1980, several major multinational corporations expressed their support of IASC. In particular, General Motors, Exxon and FMC stated that their annual reporting largely follows International Accounting Standards.

In 1981, IASC Consultative Group was formed and it included representatives from the World Bank, United Nations, Organization for Economic Cooperation and Development and other members of world community. In 1987 International Organization of Securities

Commissions joined the group, and in 1990 European Commission and Council of Financial Accounting Standards Board (USA) joined in observer status.

From 2000, International Organization of Securities Commissions recommended using IAS by transnational corporations and on the world financial markets. Developing countries used IAS as a basis for developing their own accounting standards. Lebanon and Zimbabwe, for example, legally required international standards to be used by banks and publicly traded companies. Developed countries such as Belgium, France, Italy and Germany also passed laws allowing publicly traded companies to present their consolidated financial statements using IAS without resorting to domestic accounting standards. At the end of 1990s, IAS were approved by G7 countries (USA, Japan, Germany, Great Britain, France, Italy and Canada), Basel committee on Banking supervision and Bank for International Settlements. By 2000, 143 professional accounting organizations from 104 countries joined IASC and membership of IFAC grew from 63 founding organizations from 51 countries to 173 full and associate members from 129 countries and jurisdictions.

From 1973 to 2003, IASC issued 41 standards under the common name International Accounting Standards as well as a Conceptual Framework.

In the first years of its existence, IASC focused its efforts on creation of international accounting standards. However, their implementation had little success because most major developed nations continued to use their own accounting standards, commonly known as Generally Accepted Accounting Principles. Although members of IASC pledged to cooperate with and facilitated the development of IAS, at the end of the day they did not treat these standards as their nationally accepted standards. The reasons for the lack of support for IAS have been studied extensively. For example, Basoglu and Goma note that a) international accounting standards were not sufficiently complete b) international accounting standards were excessively flexible. The standards allowed for too many alternative calculations and interpretations and that was unacceptable for accounting practitioners in most countries

After careful consideration, in the year 2000 IASC changed its name to International Accounting Standards Board (IASB) and the standards developed by this entity were also given a new name after 2001 International Financial Reporting Standards (IFRS). This name change came with a fundamental change in the structure of the organization as well as its mission: Instead of striving for harmonization of accounting standards, the goal was stated as «convergence» of national accounting standards with international standards of financial reporting.

In 2002, European Union legislation the use of IFRS for financial reporting by publicly traded companies starting in 2005. At the same time, EU decided to use its own European version of IFRS whose standards have been approved by the European Commission. IFRS and their interpretations that were accepted by EU were made available in all official languages of EU and are published in an official journal of EU. This decision to make IFRS the official standards influenced their further proliferation into more countries. Gradual modification of national standards of accounting and their gradual convergence with IFRS, namely in developed countries would have been unlikely to occur if it wasn't for adoption of IFRS by EU. Almost simultaneously with EU's decision, Financial Reporting Council (FRC) of Australia announced its acceptance of IFRS by January 1 2005.

In December of 2002, Financial Accounting Standards Board (USA) and IASB conducted a joint meeting in Norfolk, Connecticut (USA) and pledged future cooperation in

moving IFRS and GAAP toward a common set of standards. Representatives of FASB recognized the need for high-quality international accounting standards to be used for financial reporting by multinational corporations. Taking into account the fact that GDP of USA is more than 20 per cent of the world GDP, support for such standards would have a substantial impact on the success of their implementation.

Therefore, starting in 2000, international system of accounting receives global support and spreads into many countries all over the globe.

Implementation of IFRS in the world

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

Source: http://www.iasplus.com/en/resources/ifrs-topics/use-of-ifrs.

2.7 Identical changes in international accounting:

Accounting trends are developments and reactions to changing landscapes, technology and other market forces that shape the accounting profession as we know it today. How is the accounting industry changing? The change is rapid and driven largely by lightning-fast advances in technology. In many ways, the pandemic has accelerated that adoption.

For example, a wider adoption of cloud-based accounting software, as well as a move toward automation and artificial intelligence is evidence.

2.7.1 Technology and Automation:

Ever-evolving technology and a trend toward automation of repetitive accounting tasks are some of the most exciting developments in the accounting industry. Some of the processes that are being automated include approval workflows, bank reconciliation, journal entries, inter-company consolidation, revenue recognition, lease accounting and depreciation.

While there are many accounting functions that can be automated, there is a lack of understanding of the technologies and a lack of resources to implement them. But those that take the leap are reaping the benefits. 70 percent of the companies that have automated more than one-fourth of their accounting functions report moderate or substantial ROI.

2.7.2 Role of Artificial Intelligence (AI):

Across industries there’s consensus that AI can and will have a significant impact on finance and accounting. Companies are using AI and robotic process automation (RPA) to automate mundane, highly repeatable tasks, allowing accountants to focus their time on higher impact and higher value activities. Accounting Firm, for example, has applied AI to the analysis of lease contracts to make it easier to capture information quickly on commencement date, amount to be paid, termination or renewal options and allow the finance professional to spend more time on making decisions with the data instead of looking for it.

2.7.3 Accounting Software:

For RPA to be successful, transactional data needs to be standardized and merged from multiple sources in multiple formats, also known as harmonizing. Harmonization can involve bringing together structured, semi-structured and unstructured data within a single system. AI needs vast amounts of data to be effective. And above all, the outputs of all enabling technologies need to be trusted by the accountants. That's where accounting software comes in.

36 percent of companies plan to implement cloud-based accounting solutions in the near future. Enterprise resource planning (ERP) systems can integrate your accounting software and your financial data with other important areas of your business, such as supply chain, order and production management. An integrated ERP platform consolidates data from these different areas to give you more actionable insight into your business.

2.7.4 Data Analytics and Forecasting Tools:

Among the accounting tips for both small businesses and larger companies, increasing the use of budgeting, forecasting and planning software, as well as data analytics and visualization tools is one of the most impactful. Finance functions are becoming significantly more analytical and technology will help push the accounting and finance department from reactionary and transactional to proactive and analytical. As evidence of the demand for the increasingly analytical and tech-savvy accountant, IMA recently launched it's a Data Analytics & Visualization Fundamentals Certificate. The program is designed to equip accounting and finance professionals with the strong critical thinking, problem-solving and technology skills needed to advance business strategy.

2.7.5 Digital Transformation:

Faster than perhaps ever before, organizations are transforming how they do business with the aid of digital technology and accounting and finance teams have been at the heart of it all. They have put processes in place to account for new revenue from subscription models, new channels, new physical and digital product offerings and more. One of the most pressing accounting challenges is leveraging technology to support the business strategy and adapt to changing conditions.

2.7.6 Workplace Wellness:

Workplace wellness programs continue to be a popular perk provided by employers but managing these programs can be complex for accountants. For example, payroll managers and accountants must make sure the discounts employees earn on health insurance through wellness programs are calculated correctly as withholdings in paychecks. Accountants must also be mindful of changes to tax laws that impact how the items in the wellness program count toward tax deductible business expenses. In addition to hopefully boosting the health of employees, wellness programs can be a useful tool for employee engagement. Accountants continue to report high rates of burnout and stress due to managing too many responsibilities and should take advantage of programs whenever possible.

2.8 International accounting – new adoptions:

Accounting system modifications and adoptions are leads to new areas and concept in international accounting benefits and ideologies. Some of the convenience methods are discussed below:

2.8.1 Online Collaboration and Remote Workforce:

Especially useful with the trend of remote working, cloud-based software allows teams that are physically dispersed to collaborate and accomplish critical financial processes, such as month-end close from anywhere with a computer and an internet connection. Accounting will need collaboration tools, such as Zoom, fort and functional collaboration tools for e-signature and cloud-based file sharing.

2.8.2 Evolution of the Accountant Role:

In the future for accounting, more transactional work will become automated, and accountants will increasingly be seen as leaders and decision makers. More and more, accountants must rely on the so-called soft skills, leadership and other traits associated with emotional intelligence. These skills, paired with training to leverage insight from data analysis and the financial expertise, are what will make for successful careers in the future.

2.8.3 Data Security:

Data breaches are a bigger risk than ever, and finance departments are one of the leading targets. The breaches can lead to identity theft, or the stealing of personal data and credit card information, and spoofing, which is when an email is disguised to appear to come from a known and trustworthy source. Training in recognizing potentially harmful emails and spotting attacks will continue to be crucial for accounting teams, who are already skilled in looking at the details and spotting anomalies. The accounting team can share the importance and become champions of cyber security for your organization.

2.8.4 Changes in Tax Policy:

During the year 2022 due to the unexpected situations regarding to the COVID environment introduced which known as the COVID stimulus accountants have their work cut out for them. Passed shortly before tax season in 2022, it’s just the latest in a string of tax policy and regulatory changes, including tax extenders, PPP expense deduction, second draw PPP loans and simplified process for PPP loans under existing situations. Whether it’s understanding total tax liability or navigating shifting trade and tariff policies, understanding changes in tax policy is vital.

2.8.5 Statutory and Regulatory Compliance:

Aside from taxes, accounting and finance teams need to be mindful of shifting statutory and regulatory changes. Monitor and account for regulations, including COVID stimulus legislation. Changes in leadership at the SEC are likely to impact financial reporting requirements and scrutiny.

2.8.6 Environmental, Social and Corporate Governance (ESG):

ESG will be in sharp focus for companies, and it’s widely expected there will be new federal regulations pertaining to the areas within it especially as it relates to financial disclosures for public companies. These disclosures are likely to include mandated disclosure of climate related financial risks and greenhouse-gas emissions in your operations, as well as your supply chains. Additionally, major investors are calling for increased diversity, which affects all areas of your business, including finance and accounting. Professional trade organizations are aiming to help accountants prepare.

2.8.7 Accounting Standards:

In the recent past throughout the year, the Financial Accounting Standards Board (FASB) has issues accounting standards updates about changes that could affect financial

statements and how to keep them GAAP compliant. For 2021, there are changes related to asset acquisitions, credit losses, debt securities, leases, reorganizations, variable interest entities, and banking regulation disclosures.

2.8.8 Proactive Accounting:

Machine learning and outsourcings are being used to reframe the approach to accounting. What's become known as continuous accounting uses automation and other technology to embed tasks that are normally done at a period's end into normal day-to-day activities. But the benefit of continuous accounting isn't just fewer late nights for your accounting team. By automating repetitive tasks, you improve efficiency and data integrity, which frees up time for your accounting team because errors can be a frequent source of time-consuming work. Your team can then focus on a culture of continuous improvement by monitoring for efficiencies in processes.

2.8.9 Outsourcing:

Organizations of all sizes may find some benefit in outsourcing some or all of their finance and accounting functions. Smaller companies outsource accounting to avoid hiring additional headcount. Larger firms may outsource some or all of their accounts; this is generally done to save money. Additionally, outsourcing can sometimes give you access to skill sets, technology and expertise your company would not easily or affordably replicate by hiring new headcount and investing in your own infrastructure.

The year 2023 will continue to allow accountants to showcase their resilience and their indispensable role in the business. They'll adapt to and adopt trends to help guide and lead their businesses into the next phase of whatever the business journey entails.

2.9 Summary:

International accounting system is evaluating gradually with removal of weaknesses in the previous practices. The system overcomes the weaknesses of complexity, inadequate transparency and information etc. The development has taken place in various stages. After formation of the international accounting standard board, it takes steps to make proper guidelines the accounting system growing very rapidly. All most all the countries in the world have taken membership in these organizations. We found the drastically and identical changes in the accounting system in the recent past.

2.10 Key words:

Complexity: The complexity of a physical system or a dynamical process expresses the degree to which components engage in organized structured interactions. High complexity is achieved in systems that exhibit a mixture of order and disorder (randomness and regularity) and that have a high capacity to generate emergent phenomena.

AICPA: The American Institute of Certified Public Accountants (AICPA) is a non – profit professional organization representing certified public accounts (CPA) in the United States.

Digital Transformation: Digital transformation is the integration of digital technology into all areas of a business, fundamentally changing how you operate and deliver value to customers. It's also a cultural change that requires organizations to continually challenge the status quo, experiment, and get comfortable with failure.

Proactive Accounting: Proactive accounting takes active steps to understand the financial insights of the business. It identifies the areas where the money is going out unnecessary and makes the important financial things to be done at priority.

Forecasting: Forecasting is a technique that uses historical data as inputs to make informed estimates that are predictive in determining the direction of future trends. Businesses utilize forecasting to determine how to allocate their budgets or plan for anticipated expenses for an upcoming period of time.

Outsourcing: Outsourcing is a business practice in which a company hires a third party to perform tasks, handle operations or provide services for the company. The outside company, which is known as the service provider or a third – party provider, arranges for its own workers or computer systems to perform the tasks or services either onsite at the hiring company's own facilities or at external locations.

2.11 Self – assessment questions:

1. What are the weaknesses of traditional accounting system?
2. Write different stages in adoption of IFRS.
3. What is the impact of IASC on international accounting system?
4. What are the identical changes in international accounting?
5. What are the new adoptions in international accounting?

2.12 Further readings:

1. Frederick D.S. Choi and Gary K. Meek.: International Accounting.: Pearson
2. Timothy S. Doupnik and Mark S. Bettner.: International Financial Reporting Standards.: Pearson
3. Warren J. Samuels and K. R. J. Tresman.: Historical Perspectives on Accounting and Financial Reporting.: Routledge
4. Christopher Nobes and Robert H. Parker.: Comparative International Accounting.: Pearson
5. D. R. Carmichael and O. Ray Whittington.: Accountants' Handbook, Special Industries and Special Topics.: Wiley
6. Sidney J. Gray, Lee D. Parker, and Richard B. Niskala.: International Accounting and Multinational Enterprises.: Wiley
7. J. Edward Ketz.: Hidden Financial Risk: Understanding Off-Balance Sheet Accounting.: Wiley
8. Ikujiro Nonaka, Hitotsubashi University.: The Knowledge-Creating Company: How Japanese Companies Create the Dynamics of Innovation.: Oxford University Press
9. Paul Pacter and Thomas R. Weirich.: International Financial Reporting Standards: A Practical Guide.: Wiley
10. Raymond J. Elder and Sidney J. Gray.: International Accounting and Multinational Enterprises.: Wiley

Dr. Krishna Banana

Lesson – 3

INNOVATIONS IN INTERNATIONAL ACCOUNTING:

Learning objectives:

- ✓ To know the innovations in international accounting
- ✓ To understand the recent trends in international accounting
- ✓ To understand over the cross-border operations
- ✓ To understand the various operations of MNCs
- ✓ To know the regulatory compliance on international accounting

Structure:

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3.1 What is Innovation Accounting?
3.1.1 Tactical innovation accounting
3.1.2 Managerial innovation accounting
3.1.3 Strategic innovation accounting
3.2 Recent trends in international accounting
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3.2.2 Role of Artificial Intelligence (AI):
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3.4 Globalization and Cross-Border Operations
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3.4.2 Harmonization of Accounting Standards
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3.5 Multinational Corporations (MNCs) and Consolidated Reporting
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3.8 MNCs and Intercompany Transactions
3.9 Differences in Accounting Standards
3.10 Regulatory Compliance and MNCs
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3.0 Introduction:

To build successful innovation ecosystems, corporate entities should not exclusively look at traditional accounting methods to manage innovation and measure the impact, but at the same time, they should neither base their decision-making on intuition or faith.

To make informed investment decisions on corporate startups and ventures, managers need accounting metrics that are fact-based, and that reflect the entire process of innovation rather than just the financial outcome. Managers need an accounting system that is designed to complement the shortcomings of a financial accounting system when it comes to measuring innovation.

3.1 What is Innovation Accounting?

Innovations in accounting focus on managing the following three innovation activities:

1. Making investment decisions on different ventures at different points in their innovation journey.

2. Tracking and measuring the success of specific innovation projects.

3. Assessing the impact that innovation is having on the business as a whole.

That means that Innovation Accounting needs to be implemented at different levels of the innovation ecosystem. Within the innovation accounting framework, there are three layers of indicators that feed one into the other. It gathers data on an individual venture level to make sure that investment decisions are being made through data rather than gut feeling. That data is aggregated to make sure there is insight in the entire funnel of ventures and abstracted again to translate into strategic indicators relevant for the board and the overall strategy of the company.

3.1.1 Tactical innovation accounting:

It is connected to measuring teams. These focus on product teams, the experiments they are running, the learning they are having, and the progress they are making from ideation to scale.

3.1.2 Managerial innovation accounting:

It connected to Measuring funnel. The focus here is on helping the company make informed investment decisions based on evidence and the current innovation stages teams are in.

3.1.3 Strategic innovation accounting:

It is connected to Measuring ecosystem. The focus here is on helping a company's board examine the overall performance of their investments in innovation in the context of the larger business, connecting to overall strategy as well as decisions on capability and culture.

In order to measure your whole innovation ecosystem, and get the most accurate, reliant, and timely data, we encourage you to also measure:

- The startup collaborations to better manage your collaboration projects and maximize the value of the partnership between corporations and startups.

- Innovation HR capabilities to make sure you have the right mix of people with the right skill sets.
- Innovation culture to make sure that your organization has a setting in which innovation can drive.

3.2 Recent trends in international accounting:

Accounting trends are developments and reactions to changing landscapes, technology and other market forces that shape the accounting profession as we know it today. How is the accounting industry changing? The change is rapid and driven largely by lightning-fast advances in technology. In many ways, the pandemic has accelerated that adoption. For example, a wider adoption of cloud-based accounting software, as well as a move toward automation and artificial intelligence is evidence.

3.2.1 Technology and Automation:

Ever-evolving technology and a trend toward automation of repetitive accounting tasks are some of the most exciting developments in the accounting industry. Some of the processes that are being automated include approval workflows, bank reconciliation, journal entries, inter-company consolidation, revenue recognition, lease accounting and depreciation.

While there are many accounting functions that can be automated, there is a lack of understanding of the technologies and a lack of resources to implement them. But those that take the leap are reaping the benefits. 70 percent of the companies that have automated more than one-fourth of their accounting functions report moderate or substantial ROI.

3.2.2 Role of Artificial Intelligence (AI):

Across industries there's consensus that AI can and will have a significant impact on finance and accounting. Companies are using AI and robotic process automation (RPA) to automate mundane, highly repeatable tasks, allowing accountants to focus their time on higher impact and higher value activities. Accounting Firm, for example, has applied AI to the analysis of lease contracts to make it easier to capture information quickly on commencement date, amount to be paid, termination or renewal options and allow the finance professional to spend more time on making decisions with the data instead of looking for it.

3.2.3 Accounting Software:

For RPA to be successful, transactional data needs to be standardized and merged from multiple sources in multiple formats, also known as harmonizing. Harmonization can involve bringing together structured, semi-structured and unstructured data within a single system. AI needs vast amounts of data to be effective. And above all, the outputs of all enabling technologies need to be trusted by the accountants. That's where accounting software comes in.

36 percent of companies plan to implement cloud-based accounting solutions in the near future. Enterprise resource planning (ERP) systems can integrate your accounting software and your financial data with other important areas of your business, such as supply chain, order and production management. An integrated ERP platform consolidates data from these different areas to give you more actionable insight into your business.

3.2.4 Data Analytics and Forecasting Tools:

Among the accounting tips for both small businesses and larger companies, increasing the use of budgeting, forecasting and planning software, as well as data analytics and visualization tools is one of the most impactful. Finance functions are becoming significantly more analytical and technology will help push the accounting and finance department from reactionary and transactional to proactive and analytical. As evidence of the demand for the increasingly analytical and tech-savvy accountant, IMA recently launched it's a Data Analytics & Visualization Fundamentals Certificate. The program is designed to equip accounting and finance professionals with the strong critical thinking, problem-solving and technology skills needed to advance business strategy.

3.2.5 Digital Transformation:

Faster than perhaps ever before, organizations are transforming how they do business with the aid of digital technology and accounting and finance teams have been at the heart of it all. They have put processes in place to account for new revenue from subscription models, new channels, new physical and digital product offerings and more. One of the most pressing accounting challenges is leveraging technology to support the business strategy and adapt to changing conditions.

3.2.6 Workplace Wellness:

Workplace wellness programs continue to be a popular perk provided by employers but managing these programs can be complex for accountants. For example, payroll managers and accountants must make sure the discounts employees earn on health insurance through wellness programs are calculated correctly as withholdings in paychecks. Accountants must also be mindful of changes to tax laws that impact how the items in the wellness program count toward tax deductible business expenses. In addition to hopefully boosting the health of employees, wellness programs can be a useful tool for employee engagement. Accountants continue to report high rates of burnout and stress due to managing too many responsibilities and should take advantage of programs whenever possible.

3.3 Enhanced role of international accounting:

International accounting, a dynamic field within the realm of finance and accounting, encompasses a wide range of principles, practices, and standards that facilitate the preparation and analysis of financial information on a global scale. As businesses increasingly operate across borders and financial markets become more interconnected, the scope of international accounting has expanded significantly. This essay delves into the multifaceted scope of international accounting, highlighting its key components and the growing importance of harmonized accounting standards in today's globalized world.

3.4 Globalization and Cross-Border Operations:

The impact of globalization and cross-border operations on international accounting in the recent past has been profound and transformative. These two interconnected forces have reshaped the way businesses operate, financial transactions are conducted, and accounting standards are developed and applied worldwide. Here are some key aspects of their impact:

3.4.1 Complexity and Diversity of Transactions:

Globalization has led to a significant increase in the complexity and diversity of financial transactions. Companies now engage in cross-border mergers and acquisitions, international joint ventures, and complex supply chain arrangements. This has made

accounting standards more challenging to develop and apply, as they must address a wide array of business models and transaction types.

3.4.2 Harmonization of Accounting Standards:

In response to the global nature of business operations, there has been a push for the harmonization of accounting standards. Organizations like the International Financial Reporting Standards (IFRS) Foundation have sought to create a common set of accounting principles that can be used globally. This harmonization reduces the need for multiple sets of financial statements and facilitates cross-border investments.

3.4.3 Currency Exchange Rate Fluctuations:

Cross-border operations expose companies to currency exchange rate fluctuations. This creates challenges in translating financial statements from one currency to another, as these fluctuations can impact reported profits and financial position. International accounting standards provide guidelines for dealing with these currency translation issues.

3.4.4 Transfer Pricing Regulations:

Globalization has prompted governments to pay closer attention to transfer pricing—the prices at which related entities within a multinational company trade goods, services, or intangible assets. Tax authorities have become more stringent in ensuring that transfer prices are set at arm's length to prevent tax avoidance. This has led to increased documentation and compliance requirements in international accounting.

3.4.5 Cross-Border Taxation:

Companies operating internationally must navigate complex international tax rules and regulations. Transfer pricing, double taxation, and tax treaties are just a few of the issues that impact financial reporting and tax obligations. International accounting standards play a role in helping companies report their tax liabilities accurately.

3.4.6 Risk Assessment and Disclosure:

With operations spanning multiple countries, businesses face a broader range of risks, including political, economic, and regulatory risks. International accounting standards require companies to assess and disclose these risks in their financial statements, providing stakeholders with a more comprehensive view of potential challenges.

3.4.7 Information Technology and Reporting:

Advances in information technology have enabled the real-time exchange of financial data across borders. This has streamlined reporting processes and improved transparency in international accounting. It also allows for more efficient auditing and analysis of financial information.

3.4.8 Auditing and Assurance Services:

The global nature of business operations has increased the importance of independent auditing and assurance services. Auditors play a critical role in verifying the accuracy of financial statements in an international context, ensuring that investors and other stakeholders can trust the information presented.

Globalization and cross-border operations have had a profound impact on international accounting. While they have brought about many opportunities for businesses to expand their markets and operations, they have also introduced new complexities and

challenges. As a result, international accounting standards and practices have evolved to address these changes, emphasizing the need for transparency, comparability, and compliance in the global business environment. Accounting professionals and regulatory bodies continue to adapt to these challenges to ensure the reliability and relevance of financial reporting in an interconnected world.

3.5 Multinational Corporations (MNCs) and Consolidated Reporting:

Multinational Corporations (MNCs) play a pivotal role in the global economy, and their operations span multiple countries, making their financial reporting a complex endeavor. Consolidated reporting is a critical aspect of international accounting that addresses the unique challenges faced by MNCs. Here, we'll explore the scope of international accounting with reference to MNCs and their consolidated reporting by the conical order.

> “Multinational Corporations are large companies that operate in multiple countries and often have subsidiaries, affiliates, or branches in different parts of the world. These entities conduct business transactions in various currencies and under diverse legal and regulatory frameworks”.

3.6 Subsidiary and Affiliate Accounting:

Subsidiary and Affiliate Accounting in international accounting pertains to the financial reporting of companies with ownership interests in other entities.

- A subsidiary is an entity controlled by another (parent) company, typically owning more than 50% of the voting rights.

- Affiliate accounting involves companies with significant but not majority ownership (usually 20-50%) or significant influence over the affiliate's financial and operating policies.

- International accounting standards, such as IFRS, require consolidated financial statements for subsidiaries, combining their financial data with the parent's to provide a holistic view.

- For affiliates, the equity method is typically used, reflecting the investor's proportional share of the affiliate's assets, liabilities, income, and expenses.

- Both approaches aim for accurate and transparent financial reporting, vital for stakeholders and regulatory compliance.

- Currency translation issues, particularly in subsidiaries with different functional currencies, are addressed in international accounting to ensure uniformity.

- Intercompany transactions between subsidiaries and affiliates are eliminated to avoid double counting.

- Disclosure requirements in consolidated and equity method reporting provide transparency about the nature and extent of subsidiary and affiliate relationships.

- International accounting standards play a crucial role in ensuring consistent treatment of these entities, fostering global comparability.

- Compliance with local regulations and adherence to international accounting standards are essential to avoid legal and financial risks.

MNCs typically own or control subsidiaries and affiliates in different countries. These entities may have separate legal identities, currencies, and accounting standards. International accounting standards, such as International Financial Reporting Standards (IFRS), provide guidelines for the consolidation of financial statements. Consolidation involves combining the financial information of all subsidiaries and affiliates into a single set of financial statements to present a comprehensive view of the group's financial position and performance.

3.7 MNCs and Currency Translation:

Currency translation in international accounting is the process of converting financial statements from one currency (the functional currency) to another currency (the reporting currency) for consolidation and reporting purposes. Key points about currency translation include:

- **Functional Currency:** Each entity in a multinational company operates with a functional currency, typically the currency of the primary economic environment where it operates.

- **Reporting Currency:** The reporting currency is the currency in which the consolidated financial statements of the multinational company are presented, often the currency of the parent company.

- **Foreign Exchange Rates:** Currency translation involves using exchange rates to convert the financial statements of subsidiaries or foreign operations into the reporting currency. Rates may vary, including historical rates for balance sheet items and average rates for income and expenses.

- **Impact on Financial Statements:** Currency translation can significantly affect reported profits and financial positions, especially when exchange rates fluctuate. Gains or losses from currency translation are recorded in a separate component of equity known as the "foreign currency translation reserve."

- **Consolidation:** In consolidated financial statements, currency translation is necessary to combine the financial data of entities operating in different currencies accurately.

- **International Accounting Standards:** International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) provide guidance on currency translation to ensure consistency and comparability in financial reporting across countries.

- **Translation Methods:** Two common methods for currency translation are the current rate method (using current exchange rates) and the temporal method (using historical exchange rates).

- **Translation Adjustments:** Changes in exchange rates can result in translation adjustments, impacting the carrying value of assets and liabilities on the balance sheet.

- **Hedging Strategies:** MNCs may use hedging strategies to mitigate the impact of currency fluctuations on their financial statements.

- **Disclosure:** International accounting standards require disclosure of the methods used for currency translation, the impact on equity, and information about significant exchange rate fluctuations that may affect the company.

- **Challenges:** Currency translation introduces complexities, as exchange rates are subject to volatility and can impact the comparability of financial statements across different reporting periods.

- **Consistency:** It's essential for multinational companies to apply consistent currency translation methods to maintain the integrity and reliability of their financial reporting.

One of the challenges in MNC consolidated reporting is dealing with currency translation. Subsidiaries may use different functional currencies, and fluctuations in exchange rates can impact the group's reported financial results. International accounting standards provide guidance on how to translate foreign currency financial statements into the reporting currency, often the functional currency of the parent company.

3.8 MNCs and Intercompany Transactions:

MNCs frequently engage in intercompany transactions, including the sale of goods, services, or intellectual property between subsidiaries. International accounting standards require these transactions to be eliminated during the consolidation process to prevent double counting and ensure accuracy in financial reporting. Intercompany transactions, in the context of international accounting, refer to financial transactions that occur between different entities or subsidiaries within the same multinational corporation (MNC). Key points about intercompany transactions include:

- **Definition:** Intercompany transactions involve the exchange of goods, services, loans, or other assets between entities within an MNC group.

- **Common Occurrence:** MNCs frequently engage in intercompany transactions to optimize their operations, share resources, or provide support to subsidiaries in different countries.

- **Accounting Treatment:** International accounting standards, such as IFRS, require that intercompany transactions be eliminated when preparing consolidated financial statements to prevent double counting of revenue, expenses, assets, and liabilities.

- **Transfer Pricing:** Setting appropriate transfer prices for intercompany transactions is crucial. International accounting standards emphasize that transfer prices should be set at arm's length, meaning they should be similar to what unrelated parties would agree upon in open market transactions. This helps prevent tax avoidance and ensures accurate financial reporting.

- **Documentation:** MNCs are typically required to maintain detailed documentation of their intercompany transactions to demonstrate compliance with transfer pricing regulations and international accounting standards.

- **Types of Intercompany Transactions:** These transactions can include the sale of products, provision of services, licensing of intellectual property, loans, and other financial arrangements.

- **Impact on Financial Statements:** Failing to properly account for intercompany transactions can distort a company's financial performance, as revenue and expenses may be misstated.

- **Disclosures:** International accounting standards often require companies to disclose information about significant intercompany transactions and their impact on financial statements to provide transparency to stakeholders.

- **Regulatory Scrutiny:** Tax authorities and regulatory bodies worldwide pay close attention to intercompany transactions to ensure they comply with transfer pricing regulations and international accounting standards. Non-compliance can lead to penalties and legal issues.

- **Risk Management:** Managing intercompany transactions effectively is crucial for minimizing financial and tax risks within the MNC group.

Intercompany transactions are a fundamental aspect of international accounting for multinational corporations. Proper accounting treatment, adherence to transfer pricing regulations, and transparent disclosure are essential to accurately reflect the financial performance and position of the MNC group in consolidated financial statements while complying with international accounting standards and local regulations.

3.9 Differences in Accounting Standards:

MNCs may operate in countries with varying accounting standards and regulations. International accounting standards like IFRS aim to harmonize these differences to some extent, making it easier for MNCs to prepare consolidated financial statements that comply with international norms. However, reconciling differences in accounting treatments can still be a complex task. Differences in accounting standards, in the context of international accounting, refer to variations in the principles, rules, and practices used for financial reporting among different countries or jurisdictions. Key points about these differences include:

- **Global Nature of Business:** With multinational corporations operating in various countries, differences in accounting standards arise due to the diverse regulatory environments and accounting bodies in each jurisdiction.

- **International Accounting Harmonization:** Efforts have been made to harmonize accounting standards globally to enhance comparability and transparency in financial reporting. The International Financial Reporting Standards (IFRS) is a prominent example of such harmonization.

- **Local Generally Accepted Accounting Principles (GAAP):** Many countries maintain their own set of GAAP, leading to variations in accounting treatments, terminology, and presentation in financial statements.
- **Impact on Financial Reporting:** Differences in accounting standards can result in variations in reported profits, financial positions, and key financial ratios, making it challenging for investors and stakeholders to make meaningful cross-border comparisons.
- **Convergence and Adoption:** Some countries have chosen to adopt IFRS or converge their local standards with it, aiming for greater consistency in financial reporting. Others continue to use their national GAAP, leading to ongoing differences.
- **Disclosure Requirements:** Differences extend beyond recognition and measurement of financial items to include variations in disclosure requirements and presentation in financial statements.
- **Comparative Analysis:** Companies and investors must navigate these differences when analyzing financial performance and risk, often requiring reconciliations or adjustments for meaningful cross-border comparisons.
- **Regulatory Frameworks:** Differences in accounting standards reflect variations in regulatory frameworks, cultural factors, and historical accounting practices within each country.
- **Challenges:** Companies with international operations face the challenge of complying with multiple accounting standards, potentially necessitating the maintenance of separate sets of financial statements for each jurisdiction.
- **Audit and Assurance:** Auditors operating in a global context must be familiar with and adapt to the differences in accounting standards, ensuring compliance with relevant standards in each jurisdiction.

Differences in accounting standards are a prominent feature of international accounting due to the diversity of regulatory environments across countries. While efforts to harmonize standards have made progress, these differences continue to impact financial reporting, requiring careful consideration and analysis for cross-border comparisons and international business operations.

3.10 Regulatory Compliance and MNCs:

Regulatory compliance in international accounting refers to the adherence of multinational corporations (MNCs) and other entities to the various financial reporting and disclosure regulations and standards established by national and international regulatory bodies. Key points about regulatory compliance in international accounting include:

1. **Diverse Regulatory Landscape:** Different countries have their own sets of financial reporting regulations, accounting standards, and regulatory authorities, leading to a complex and diverse landscape for MNCs.

2. **International Accounting Standards:** International accounting standards, such as the International Financial Reporting Standards (IFRS), aim to harmonize financial reporting practices globally, making it easier for MNCs to achieve compliance across borders.

3. **Local Regulations:** MNCs must comply with the financial reporting requirements of each country in which they operate, including tax authorities, securities regulators, and stock exchanges.

4. **Transparency and Accuracy:** Regulatory compliance ensures that financial statements are transparent, accurate, and provide a true representation of a company's financial position and performance, instilling confidence in investors and stakeholders.

5. **Impact on Operations:** Compliance requirements can influence the way MNCs structure their operations, accounting policies, and internal controls to meet the demands of different regulatory environments.

6. **Auditing and Assurance:** Compliance often involves independent auditing and assurance services to verify the accuracy and adherence to accounting standards and regulations. Audit reports provide assurance to stakeholders.

7. **Risk Mitigation:** Non-compliance can result in legal and financial penalties, reputational damage, and increased operational risk, emphasizing the importance of adhering to regulatory requirements.

8. **Harmonization Efforts:** International organizations like the International Accounting Standards Board (IASB) work to promote consistency and reduce regulatory fragmentation by encouraging the adoption of global accounting standards.

9. **Disclosure Requirements:** Compliance often entails comprehensive disclosures about accounting policies, risks, and contingent liabilities, ensuring transparency in financial reporting.

10. **Monitoring and Enforcement:** Regulatory bodies actively monitor and enforce compliance through inspections, audits, and investigations, holding entities accountable for adherence to financial reporting standards.

Regulatory compliance in international accounting involves navigating a complex web of national and international financial reporting regulations to ensure that MNCs and other entities accurately and transparently report their financial results. Compliance is critical for maintaining trust among investors and stakeholders and mitigating legal and operational risks associated with non-compliance. MNCs must adhere to the financial reporting and disclosure requirements of each country in which they operate. This includes complying with local regulatory authorities and stock exchanges. International accounting standards provide a framework for preparing financial statements that meet the requirements of various jurisdictions while maintaining consistency and comparability.

3.11 Transfer Pricing and MNCs:

Transfer pricing, the pricing of goods, services, or intellectual property transferred between related entities within the same MNC, is a significant concern for both financial reporting and taxation. MNCs must adhere to international accounting standards to ensure that transfer pricing practices are in line with arm's length principles and accurately reflected in financial statements. Transfer pricing in international accounting refers to the pricing of goods, services, or intellectual property transferred between related entities within a multinational corporation (MNC). Key points about transfer pricing in international accounting include:

1. **Definition:** Transfer pricing involves determining the prices at which related entities conduct transactions, as if they were unrelated parties in an open market.

2. **Arm's Length Principle:** International accounting standards, tax authorities, and regulations emphasize the arm's length principle, meaning that transfer prices should resemble what unrelated parties would agree upon under similar circumstances.

3. **Tax Implications:** Transfer pricing has significant tax implications, as it can affect the allocation of profits and tax liabilities among different jurisdictions where MNC subsidiaries operate.

4. **Complexity:** MNCs engage in various intercompany transactions, including sales, services, licensing, and loans, making transfer pricing highly complex.

5. **Regulatory Scrutiny:** Tax authorities worldwide closely scrutinize transfer pricing to prevent tax avoidance and ensure that profits are appropriately distributed among jurisdictions.

6. **Documentation Requirements:** MNCs must maintain detailed documentation to justify their transfer pricing policies, demonstrating compliance with regulations and international accounting standards.

7. **Transfer Pricing Methods:** Various methods, such as the comparable uncontrolled price method, resale price method, and cost-plus method, are used to determine arm's length transfer prices.

8. **Advance Pricing Agreements (APAs):** Some MNCs seek APAs with tax authorities to proactively agree on acceptable transfer pricing methods and prices, reducing the risk of disputes.

9. **Penalties for Non-Compliance:** Non-compliance with transfer pricing regulations can result in penalties, double taxation, and reputational damage for MNCs.

10. **Multinational Coordination:** MNCs must align their transfer pricing strategies with their overall business operations and international tax planning to optimize tax efficiency and comply with international accounting standards.

11. **Global Harmonization Efforts:** International organizations like the Organization for Economic Co-operation and Development (OECD) provide guidelines and recommendations to harmonize transfer pricing rules globally.

12. **Disclosure Requirements:** International accounting standards often require MNCs to disclose information about their transfer pricing policies, transactions, and their impact on financial statements for transparency.

Transfer pricing in international accounting is a complex and highly regulated practice that ensures related entities within an MNC conduct transactions at arm's length prices. It has profound implications for tax planning, financial reporting, and regulatory compliance, making it a critical aspect of managing the financial affairs of multinational corporations.

3.12 Disclosure and Transparency:

Given the complexity of MNC operations, international accounting standards emphasize the importance of disclosure and transparency in financial reporting. MNCs are required to provide comprehensive notes to their consolidated financial statements, detailing significant accounting policies, risks, and contingencies associated with their global operations. Disclosure and transparency in international accounting are essential principles that emphasize the clear and comprehensive presentation of financial information to stakeholders. Key points about disclosure and transparency in international accounting include:

1. **Definition:** Disclosure involves providing relevant information in financial statements and other reports to enable users to make informed decisions. Transparency ensures that this information is presented in a clear, understandable, and unbiased manner.

2. **Stakeholder Trust:** Disclosure and transparency build trust among investors, creditors, regulators, and other stakeholders by demonstrating a commitment to openness and honesty.

3. **International Accounting Standards:** International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) establish guidelines for disclosure and transparency, aiming for consistency and comparability in financial reporting.

4. **Comprehensive Reporting:** Companies are required to disclose accounting policies, significant accounting estimates, related party transactions, contingent liabilities, and other information that could impact financial statement users' understanding of a company's financial position and performance.

5. **Risk Disclosure:** Companies must disclose risks and uncertainties, including market risks, credit risks, and operational risks, allowing stakeholders to assess a company's risk exposure.

6. **Segment Reporting:** International accounting standards require disclosure of financial information for different business segments or geographical regions, providing insight into a company's diversification and performance in various areas.

7. **Fair Value Measurement:** Companies are often required to disclose the fair value of financial instruments, investments, and assets, ensuring transparency in asset valuation.

8. **Non-Financial Information:** Increasingly, companies are disclosing non-financial information related to sustainability, environmental, social, and governance (ESG) factors to meet evolving stakeholder expectations.

9. **Auditor's Report:** Audit reports provide assurance on the accuracy and completeness of financial statements, enhancing transparency by verifying the reliability of the disclosed information.

10. **Regulatory Oversight:** Regulators and stock exchanges play a role in enforcing disclosure and transparency requirements, imposing penalties for non-compliance.

11. **Global Comparability:** Disclosure standards promote global comparability of financial statements, allowing investors to assess companies across different regions and industries.

12. **Continuous Disclosure:** Companies must practice ongoing disclosure, not just in annual reports but also in interim reports and through timely announcements of significant events that may affect their financial position.

Disclosure and transparency are fundamental principles in international accounting, ensuring that financial information is presented clearly and comprehensively for the benefit of stakeholders. Compliance with established accounting standards and regulatory requirements fosters trust, facilitates informed decision-making, and promotes a more open and accountable business environment on a global scale.

The scope of international accounting in the context of MNCs and consolidated reporting is vast and intricate. It encompasses a range of challenges related to subsidiary accounting, currency translation, intercompany transactions, differences in accounting standards, regulatory compliance, transfer pricing, and the need for transparency. MNCs rely on international accounting standards to navigate these complexities and present accurate and meaningful financial information to their stakeholders, facilitating informed investment decisions and ensuring compliance with global financial reporting norms.

3.13 Financial Reporting and Investor Confidence:

Financial reporting in the scope of international accounting refers to the process of preparing and presenting a company's financial information, including its financial statements, to various stakeholders. Investor confidence is closely tied to the quality and transparency of this financial reporting. Here are key points regarding these concepts within the context of international accounting:

1. **Financial Reporting:** Financial reporting involves the preparation of financial statements, such as the balance sheet, income statement, and cash flow statement, which summarize a company's financial performance and position over a specific period. It also includes notes and disclosures that provide additional information.

2. **International Accounting Standards:** International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) are used worldwide to guide the preparation of financial statements. These standards promote consistency and comparability in reporting.

3. **Investor Confidence:** Investor confidence is the trust and assurance that investors have in a company's financial information. It is crucial for attracting investment and maintaining a healthy stock market.

4. **Quality of Information:** Investors rely on the quality of financial reporting to make informed decisions. Accurate, reliable, and transparent financial statements are essential for assessing a company's financial health and prospects.

5. **Transparency:** Transparency in financial reporting means providing a clear and comprehensive view of a company's financial affairs. This includes disclosing accounting policies, significant accounting estimates, risks, and contingent liabilities.

6. **Disclosure of Risks:** International accounting standards require companies to disclose various types of risks, such as market risks, credit risks, and operational risks. This allows investors to assess the potential challenges a company may face.

7. **Auditor Assurance:** Independent auditors play a critical role in enhancing investor confidence. They review a company's financial statements and issue audit reports to provide assurance about the accuracy and fairness of the information presented.

8. **Global Comparability:** International accounting standards promote global comparability, allowing investors to compare companies from different countries and industries more easily.

9. **Regulatory Oversight:** Regulators and stock exchanges enforce financial reporting standards to ensure compliance and integrity in financial statements. Non-compliance can lead to penalties and legal consequences.

10. **Investor Protection:** Robust financial reporting standards and practices protect investors from misleading or fraudulent financial information, fostering trust in the capital markets.

Financial reporting in international accounting is the foundation of investor confidence. The adherence to high-quality accounting standards, transparency in disclosures, and independent audit assurance all contribute to building trust among investors. This trust, in turn, attracts investment capital, promotes economic growth, and contributes to the stability and efficiency of global financial markets. International accounting is instrumental in enhancing transparency and comparability in financial reporting. Investors, whether domestic or foreign, rely on financial statements to make informed decisions about allocating their capital. The adoption of consistent international accounting standards across countries widens the scope for investors, reducing information asymmetry and increasing confidence in financial markets. A standardized approach to accounting also fosters cross-border investments and promotes capital flows.

3.14 Summary:

Innovations in International Accounting' sheds light on the ever-evolving landscape of global financial reporting. We have explored the recent trends in international accounting, revealing how it has adapted to address the challenges of an interconnected world. These innovations encompass the adoption of International Financial Reporting Standards (IFRS),

the emergence of technology-driven reporting tools, and the heightened focus on sustainability accounting. The scope of international accounting has expanded significantly, transcending geographical boundaries, as businesses, investors, and policymakers seek greater transparency and comparability in financial information. As multinational corporations (MNCs) continue to play a pivotal role in the global economy, the operations of MNCs have become inextricably linked with international accounting practices, impacting both financial reporting and decision-making processes. As we move forward, it is clear that 'Innovations in International Accounting' will remain a critical subject, continually adapting to address the complex challenges posed by a dynamic global business environment. Embracing these innovations is crucial for MNCs and all stakeholders involved in international accounting, as it paves the way for more accurate, relevant, and reliable financial information that supports informed decision-making and fosters trust in the global marketplace."

3.15 Key words:

Strategic innovations: Strategic innovation is an organization's process of reinventing or redesigning its corporate strategy to drive business growth, generate value for the company and its customers, and create competitive advantage. This type of innovation is essential for organizations to adapt to the speed of technology change.

Artificial intelligence: Artificial intelligence (AI) is a wide-ranging branch of computer science concerned with building smart machines capable of performing tasks that typically require human intelligence. While AI is an interdisciplinary science with multiple approaches, advancements in machine learning and deep learning, in particular, are creating a paradigm shift in virtually every sector of the tech industry.

Accounting software: Accounting software manages and records the day-to-day financial transactions of an organization, including fixed asset management, expense management, revenue management, accounts receivable, accounts payable, subledger accounting, and reporting and analytics. A complete accounting system keeps track of an organization's assets, liabilities, revenues, and expenses. These transactions then populate the general ledger in real time, providing CFOs, treasurers, and controllers immediate access to real time, accurate financial data. It also allows P&L owners visibility into their performance at the operational level.

Data analytics: Data analytics is a multidisciplinary field that employs a wide range of analysis techniques, including math, statistics, and computer science, to draw insights from data sets. Data analytics is a broad term that includes everything from simply analyzing data to theorizing ways of collecting data and creating the frameworks needed to store it.

Cross border operations: Cross-border operations are transactions between residents of different countries. External Debt; Definition, Statistical Coverage and Methodology, A Report by an International Working Group on External Debt Statistics of the World Bank, IMF, BIS, OECD, OECD, Paris, 1988, Glossary.

3.16 Self – assessment questions;

1. What are the recent developments in international accounting?
2. Find the innovations in international accounting.
3. Write a note on globalization and cross border operations.
4. What are the prime operations of MNCs in connection with accounting?

5. Write a note on MNCs and transfer pricing.
6. How investor confidences hike with financial reporting?

3.17 Further readings;

1. Chris Nobes; The Economics of International Accounting; Routledge
2. Tim E. Becker, Mark L. DeFond, and Wayne R. Landsman; Advances in International Accounting; Emerald Publishing
3. Warren J. Samuels and K. R. J. Tresman; Historical Perspectives on Accounting and Financial Reporting; Routledge
4. Anne Christine Brusendorff and Günther Gebhardt; Innovations in International and Cross-Cultural Management; Springer
5. D. R. Carmichael and O. Ray Whittington; Accountants' Handbook, Special Industries and Special Topics; Wiley
6. Timothy S. Doupnik and Mark S. Bettner; International Financial Reporting Standards; Pearson
7. Christopher Nobes and Robert H. Parker; Comparative International Accounting; Pearson
8. Sidney J. Gray, Lee D. Parker, and Richard B. Niskala; International Accounting and Multinational Enterprises; Wiley
9. Shahrokh M. Saudagaran; International Accounting; A User Perspective; South-Western College Pub
10. Paul Pacter and Thomas R. Weirich; International Financial Reporting Standards; A Practical Guide; Wiley

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Lesson – 4

SCOPE, IMPORTANCE AND REGULATION OF INTERNATIONAL ACCOUNTING

Learning objectives:

- ✓ To know the scope of international accounting
- ✓ To understand the role of various accounting systems
- ✓ To know the relationship among the different accounting systems
- ✓ To understand the ethical considerations of international accounting
- ✓ To know complex financial instruments in accounting system.

Structure:

4.0 Introduction
4.1 Scope of international accounting
4.2 Financial accounting and International Accounting
4.3 Management accounting and international accounting
4.4 Social and allied accounting activities and International accounting
4.5 Scope of international accounting and other fields of accounts
4.6 Importance of international accounting
4.7 Regulatory Framework and Compliance
4.8 Accounting for Complex Financial Instruments
4.9 Ethical Considerations and Sustainability Reporting
4.10 Summary
4.11 Key words
4.12 Self – assessment questions
4.13 Further readings

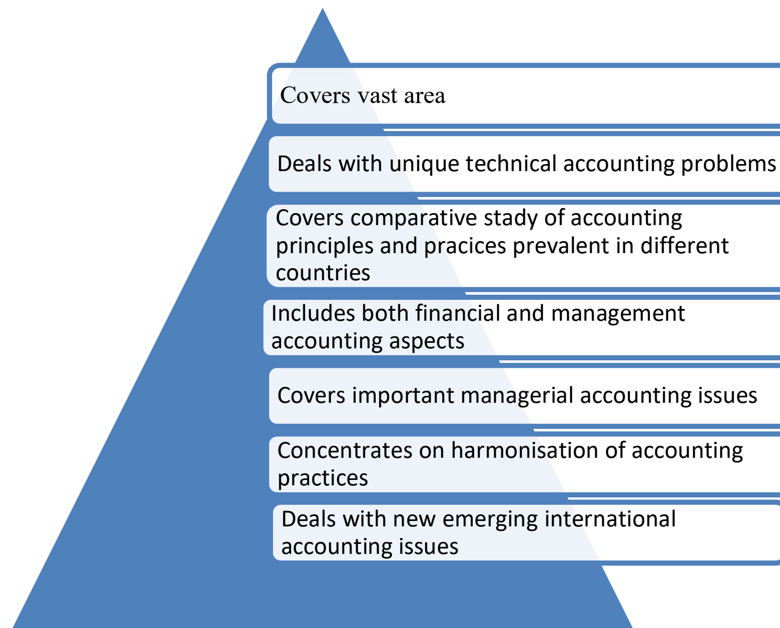
14.0 Introduction:

International accounting is a subject encapsulates a wide array of principles, practices, and regulations that govern how organizations, both domestic and multinational, prepare and present their financial information. The scope of international accounting extends beyond borders, encompassing diverse accounting standards, practices, and reporting requirements that vary from one country to another. Understanding this scope is fundamental for businesses, investors, and professionals operating in the international arena. The importance of international accounting cannot be overstated. It facilitates cross-border trade and investment, fosters transparency, and enables informed decision-making. Moreover, it enhances the comparability of financial information, which is essential for global investors and stakeholders. In the backdrop of this expansive landscape, regulation assumes a pivotal role. International bodies and national authorities have established a framework to standardize financial reporting, exemplified by the International Financial Reporting Standards (IFRS). These regulations ensure consistency and integrity in the global financial marketplace.

4.1 Scope of international accounting:

Accounting is aptly called ‘the language of businesses. It is through accounting that business communicates to be stakeholders. Accounting acts as basic source of information for business and economic decisions. The important categories of accounting contained in accounting information, financial accounting information and tax accounting information. International accounting would involve accounting for international transactions. Comparison

of accounting principles and practices found in foreign countries and the procedures by which they were established. One country accounting reviews its international accounting.



4.2 Financial accounting and International Accounting:

The scope of international accounting within the realm of financial accounting focuses on the application of accounting principles, standards, and practices in a global context specifically related to financial reporting and financial statement preparation. Here's a closer look at the scope of international accounting within the domain of financial accounting:

1. **International Financial Reporting Standards (IFRS):** IFRS is a central component of international financial accounting. Many countries around the world have adopted IFRS or have converged their national accounting standards with IFRS. The scope involves understanding and applying these global accounting standards in financial reporting.
2. **Global Companies:** Large multinational corporations (MNCs) with operations in multiple countries must prepare consolidated financial statements that comply with international accounting standards. This includes converting financial statements from different currencies and aligning accounting practices across diverse jurisdictions.
3. **Foreign Currency Transactions**: International financial accounting involves dealing with foreign currency transactions. Accountants must recognize and account for gains or losses due to fluctuations in exchange rates when translating foreign subsidiary financial statements into the reporting currency of the parent company.
4. **Financial Instruments**: The scope includes accounting for complex financial instruments and derivatives used for risk management, such as hedging foreign exchange risks.
5. **Revenue Recognition:** International accounting standards, including IFRS 15, provide guidance on how to recognize revenue from contracts with customers. Understanding and applying these standards is essential for financial accountants.

6. **Leases:** The adoption of IFRS 16 has changed the way leases are accounted for in financial statements. International accountants need to be familiar with the new lease accounting rules.
7. **Consolidation:** Understanding the principles of consolidation is crucial for companies with subsidiaries, joint ventures, or associates in different countries. IFRS 10 and IAS 28 provide guidance on the accounting for investments in these entities.
8. **Business Combinations**: International financial accountants must be well-versed in the accounting for business combinations, including mergers and acquisitions, as per IFRS 3.
9. **Financial Disclosures:** International accounting standards outline the required disclosures in financial statements, which may include additional information compared to national standards. Accurate and comprehensive disclosures are a key aspect of financial accounting in an international context.
10. **Financial Reporting Framework**: Financial accountants must navigate between international accounting standards (IFRS) and national accounting standards when applicable, ensuring compliance with both when necessary.
11. **Auditing and Assurance**: Auditing standards can vary internationally. Financial accountants should collaborate with auditors who understand the specific international auditing requirements.
12. **Regulatory Compliance:** International accountants need to ensure that financial statements comply with the regulatory and reporting requirements of the countries in which the company operates.
13. **Tax Implications**: Understanding the international tax environment is essential as tax rules can affect the financial statements and financial position of a company. Tax provisions and deferred tax assets/liabilities are part of financial accounting considerations.

The scope of international accounting within financial accounting is essential for organizations that operate on a global scale. Adherence to international accounting standards, as well as knowledge of local regulations, cultural differences, and foreign exchange impacts, are crucial to producing accurate and reliable financial statements that meet the needs of investors, regulators, and other stakeholders in various countries.

4.3 Management accounting and International accounting:

The scope of international accounting in the context of management accounting encompasses various aspects of accounting and financial management practices that are influenced by or impact international business operations. Management accounting primarily focuses on providing relevant financial and non-financial information to aid decision-making and strategic planning within organizations. When applied in an international setting, management accounting extends to address the complexities of operating in a global environment. Here's a closer look at the scope of international accounting within the realm of management accounting:

1. **Global Strategy and Planning:** Management accountants need to consider international factors when formulating business strategies and financial plans. This includes assessing market dynamics, economic conditions, and regulatory environments in different countries.
2. **Budgeting and Forecasting:** Developing budgets and financial forecasts for global operations involves understanding and accounting for variations in currencies, inflation rates, and market conditions across different regions.

3. **Transfer Pricing:** Managing transfer pricing in a multinational organization involves determining appropriate prices for goods, services, or intellectual property transferred between different subsidiaries, considering the tax implications and compliance with international guidelines.
4. **Cost Allocation**: Allocating costs to different divisions or business units across borders can be complex, and management accountants must consider issues related to exchange rates, inflation, and varying cost structures in different countries.
5. **Performance Measurement:** Performance metrics and key performance indicators (KPIs) should be designed to account for global operations and must be consistent across diverse regions to enable meaningful performance evaluations.
6. **Risk Management:** Management accountants in an international context play a crucial role in identifying, measuring, and mitigating financial risks, including currency risk, political risk, and market risk.
7. **Strategic Investment Decisions:** Assessing and evaluating the financial viability of international investment opportunities, such as mergers and acquisitions, joint ventures, or expansions into new markets is a vital aspect of management accounting in an international context.
8. **Supply Chain and Inventory Management:** Coordinating and optimizing supply chains across borders requires international management accountants to analyze costs, lead times, and transportation costs while ensuring efficient inventory management.
9. **Tax Planning:** Management accountants need to work closely with tax professionals to ensure that the organization is optimizing its international tax strategy and staying compliant with tax laws in various countries.
10. **Market Entry and Expansion:** When entering new international markets, management accountants need to assess the financial viability and risks associated with market entry, considering factors such as regulatory compliance, pricing, and local competition.
11. **Currency Exchange Management:** Managing exposure to foreign exchange risk is a critical task for international management accountants. This may involve using financial instruments like forward contracts to hedge against currency fluctuations.
12. **Cultural and Legal Differences:** Management accountants must consider cultural differences and varying legal and regulatory environments in different countries, as these factors can impact financial and management practices.
13. **Reporting for Decision-Making:** Providing management with international financial and non-financial information in a clear and relevant manner to support effective decision-making is a fundamental aspect of management accounting in the global context.

The scope of international accounting in management accounting is broad and dynamic, reflecting the increasing globalization of business operations. Management accountants play a crucial role in helping organizations navigate the challenges and opportunities of international markets while ensuring that financial information is used effectively for strategic decision-making.

4.4 Social and allied accounting activities and international accounting:

The scope of international accounting in the context of social and allied accounting activities extends beyond traditional financial accounting and management accounting to encompass a broader set of activities related to social, environmental, and ethical aspects of business. This branch of international accounting is often referred to as "sustainability accounting" or "corporate social responsibility (CSR) accounting." It involves the

measurement, reporting, and analysis of non-financial information that is relevant to an organization's social, environmental, and ethical performance. Here's an overview of the scope of international accounting with respect to social and allied accounting activities:

1. **Sustainability Reporting:** International accounting standards and frameworks, such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB), provide guidance on how organizations should report on their sustainability initiatives. The scope includes the measurement and disclosure of environmental, social, and governance (ESG) indicators.
2. **Triple Bottom Line Reporting:** International accounting in the context of social and allied accounting activities goes beyond profit and loss to consider the "triple bottom line," which includes economic, social, and environmental impacts. Organizations must account for their social and environmental performance alongside their financial performance.
3. **Integrated Reporting:** Some international organizations promote the concept of integrated reporting, which seeks to provide a holistic view of an organization's performance by integrating financial and non-financial information in a single report.
4. **Environmental Accounting:** Organizations must account for and report on their environmental impacts, including energy consumption, greenhouse gas emissions, water usage, waste generation, and other environmental indicators. This information helps stakeholders understand the organization's environmental sustainability efforts.
5. **Social Accounting:** Social accounting encompasses reporting on an organization's social performance, including aspects like labor practices, diversity and inclusion, employee well-being, and community engagement. It may involve reporting on social impact and contributions to local communities.
6. **Ethical Accounting:** International accounting standards often include ethical considerations, such as anti-corruption measures, ethical supply chain practices, and adherence to international norms and standards, like the UN Global Compact.
7. **Human Rights Reporting:** In the context of international accounting, organizations may be required to report on their efforts to respect and protect human rights in their operations and supply chains, especially in industries with a high risk of human rights abuses.
8. **Stakeholder Engagement:** International accounting frameworks often emphasize the importance of engaging with stakeholders, including investors, customers, employees, and communities, to understand their expectations and concerns related to social and environmental performance.
9. **Assurance and Verification:** Ensuring the credibility of social and allied accounting reports may require external assurance or verification by auditors or third-party organizations to validate the accuracy and completeness of the reported information.
10. **Regulatory Compliance:** International organizations and countries may have varying regulatory requirements related to social and environmental reporting, and international accountants need to ensure compliance with these regulations.
11. **Sustainable Development Goals (SDGs):** Some organizations align their social and allied accounting activities with the United Nations Sustainable Development Goals (SDGs) and report on their contributions to achieving these global objectives.
12. **Corporate Governance:** Corporate governance principles and reporting are often integrated into sustainability reporting, ensuring that organizations disclose their governance practices and structures related to ESG issues.

The scope of international accounting in the realm of social and allied accounting activities reflects the growing importance of sustainability and corporate social responsibility in the global business landscape. Organizations are expected to account for and report on their social, environmental, and ethical performance alongside their financial performance to meet the expectations of stakeholders, including investors, customers, and regulatory bodies.

4.5 Scope of international accounting and other fields of accounts:

Scope of International Accounting

Financial Accounting	Management Accounting	Social and Allied Accounting Activities
Recording of foreign transactions	Analysis of foreign financial statements	Social accounting
Foreign currency translation	Multinational transfer pricing	Accounting for newer financial instruments
Accounting for foreign inflation	Budgeting and performance evaluation of foreign subsidiaries	Accounting for mergers and acquisitions
Consolidation of foreign financial statements, reporting and disclosure	Management of foreign exchange risk	Global Joint ventures
Segment and interim reporting	International taxation	Environmental and social disclosure
		Integration of ethics into accounting curriculum

Source: https://www.slideshare.net/

4.6 Importance of international accounting:

International accounting is of paramount importance for several reasons:

1. **Global Business Operations:** As businesses expand and operate internationally, international accounting provides a standardized framework for financial reporting, making it easier to understand and compare financial information across different countries and regions.
2. **Investor Confidence:** Standardized international accounting standards, such as International Financial Reporting Standards (IFRS), enhance transparency, consistency, and comparability in financial reporting. This, in turn, boosts investor confidence and encourages foreign investment.
3. **Cross-Border Investments:** International accounting allows investors to assess the financial health and performance of companies from various countries, facilitating cross-border investments and diversification of investment portfolios.
4. **Mergers and Acquisitions:** Companies engaging in mergers, acquisitions, or partnerships with foreign entities rely on international accounting to assess the financial position and performance of potential targets accurately.
5. **Regulatory Compliance:** Multinational corporations must adhere to the financial reporting regulations of the countries in which they operate. International accounting standards help these companies navigate the complexities of compliance in different jurisdictions.

6. **Efficiency and Cost Savings:** Standardized accounting practices reduce the administrative burden and costs associated with preparing financial statements for multiple countries, streamlining reporting processes.
7. **Risk Management:** Multinational corporations use international accounting to manage currency risk, interest rate risk, and other financial risks associated with their global operations.
8. **Global Capital Markets:** International accounting standards promote the integration of global capital markets by providing a common financial reporting language, making it easier for companies to access capital worldwide.
9. **Consistency and Comparability:** The uniformity provided by international accounting standards ensures that financial statements are consistent and comparable across borders, facilitating benchmarking and performance assessment.
10. **Legal and Regulatory Compliance:** International accounting standards help companies comply with local regulations, stock exchange listing requirements, and international agreements related to financial reporting.
11. **Risk Assessment:** Investors, creditors, and other stakeholders can assess the financial stability and creditworthiness of foreign entities more effectively when international accounting standards are followed.
12. **Audit and Assurance:** International accounting standards guide auditors in their examination of financial statements, ensuring that companies' financial information is subjected to rigorous review and verification.

International accounting plays a crucial role in fostering transparency, enabling cross-border investment, supporting global business operations, and promoting investor confidence. It serves as a cornerstone for the international financial system, facilitating economic growth and cooperation on a global scale.

4.7 Regulatory Framework and Compliance:

Countries worldwide are increasingly adopting or converging with international accounting standards to improve the quality of financial reporting. This convergence widens the scope of international accounting by necessitating compliance with global standards. Regulatory bodies like the International Accounting Standards Board (IASB) play a pivotal role in setting and revising these standards to accommodate evolving business practices and financial instruments. The harmonization of accounting rules helps bridge gaps between national and international accounting practices. The regulatory framework and compliance in the context of international accounting are essential components that govern how businesses prepare and present their financial information. Here are key points regarding these concepts within the scope of international accounting:

1. **Regulatory Framework:** The regulatory framework refers to the set of laws, regulations, and standards that dictate how financial reporting and accounting practices are carried out within a specific country or region. It encompasses both local and international regulations.
2. **International Accounting Standards:** The International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) are examples of international accounting standards that provide a framework for financial reporting. IFRS, in particular, is widely adopted globally to enhance comparability and transparency in financial statements.

3. **Local Regulations:** Each country may have its own regulatory bodies, such as the Securities and Exchange Commission (SEC) in the United States or the Financial Reporting Council (FRC) in the United Kingdom, that establish accounting and financial reporting rules specific to that jurisdiction.
4. **Global Harmonization:** Efforts are made to harmonize international accounting standards to promote consistency in financial reporting across borders, making it easier for multinational corporations to comply with multiple regulatory regimes.
5. **Compliance Requirements:** Compliance involves adhering to the accounting standards and regulations relevant to a particular jurisdiction. This includes proper measurement, recognition, and disclosure of financial information in accordance with the applicable rules.
6. **Transparency:** Regulatory frameworks often emphasize transparency by requiring companies to disclose information about accounting policies, significant accounting estimates, related party transactions, and contingent liabilities, among other items.
7. **Financial Statement Audits:** Many regulatory frameworks require independent audits of financial statements by external auditors. Auditors assess whether the company's financial statements comply with accounting standards and regulations and provide assurance on their accuracy.
8. **Penalties for Non-Compliance:** Non-compliance with accounting regulations can result in legal penalties, fines, reputational damage, and even the suspension of trading on stock exchanges.
9. **International Compliance Challenges:** Multinational corporations face the challenge of complying with various regulatory frameworks, particularly when they operate in multiple countries with differing accounting standards.
10. **Harmonization Initiatives:** Organizations like the International Accounting Standards Board (IASB) work towards the convergence of international accounting standards and encourage countries to adopt a common set of standards to facilitate compliance.

The regulatory framework and compliance are integral to international accounting, ensuring that financial reporting is conducted in a standardized and transparent manner. Multinational corporations must navigate these frameworks to meet their obligations in various jurisdictions while maintaining consistency and accuracy in their financial statements. Complying with international accounting standards and local regulations promotes trust and confidence in financial reporting, benefiting both companies and investors.

4.8 Accounting for Complex Financial Instruments:

International accounting extends its scope to address the challenges posed by intricate financial instruments, such as derivatives, structured products, and complex securities. As financial markets innovate and diversify, international accounting standards need to evolve to provide guidelines for proper accounting and disclosure of these instruments. This adaptation ensures that financial statements accurately reflect the risk exposures and financial health of entities. Accounting for complex financial instruments within the scope of international accounting involves the recognition, measurement, and disclosure of intricate financial instruments, such as derivatives, hybrid securities, and structured products. Key points regarding this concept in international accounting include:

1. **Complex Financial Instruments:** These instruments include derivatives like options, swaps, and futures, as well as hybrid securities like convertible bonds, complex debt instruments, and structured products with embedded derivatives.
2. **Recognition and Measurement:** International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) provide guidelines for recognizing complex financial instruments on the balance sheet and measuring them at fair value or amortized cost, depending on their characteristics and the company's business model.
3. **Fair Value Accounting:** Fair value accounting is often applied to complex financial instruments, requiring companies to regularly assess and report these instruments at their current market value. This approach increases transparency but can also lead to greater volatility in financial statements.
4. **Hedge Accounting:** IFRS and GAAP provide specific guidance on hedge accounting for derivatives and other financial instruments used for risk management purposes. Hedge accounting allows companies to offset the impact of changes in fair value or cash flows of hedged items and hedging instruments, reducing income statement volatility.
5. **Disclosure Requirements:** International accounting standards mandate detailed disclosures related to complex financial instruments, including their nature, fair value, risk exposures, and terms and conditions. These disclosures aim to provide stakeholders with a clear understanding of the instruments' impact on a company's financial position and performance.
6. **Effective Interest Rate Method:** For complex debt instruments, both IFRS and GAAP require the use of the effective interest rate method to allocate interest income or expense over the life of the instrument, accounting for any changes in its carrying amount.
7. **Impairment and Credit Risk:** The accounting treatment of credit risk and impairment for complex financial instruments is another critical aspect. Companies must assess the expected credit losses and recognize impairments when necessary.
8. **Regulatory Oversight:** Regulatory bodies, such as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), continually update and refine accounting standards for complex financial instruments to address emerging issues and align with market practices.
9. **Complexity and Volatility:** Accounting for complex financial instruments can be challenging due to their intricate nature and the potential for significant valuation changes, which may result in increased income statement volatility.
10. **Auditor Scrutiny:** Auditors play a crucial role in reviewing a company's accounting for complex financial instruments, ensuring compliance with accounting standards and the appropriateness of disclosures.

Accounting for complex financial instruments in international accounting is a complex and evolving area, subject to comprehensive standards and disclosure requirements. Accurate and transparent reporting of these instruments is essential to provide investors and stakeholders with a clear understanding of a company's financial risk exposures, performance, and overall financial health.

4.9 Ethical Considerations and Sustainability Reporting:

Ethical considerations and sustainability reporting within the scope of international accounting encompass the integration of ethical principles and sustainability practices into

financial reporting and corporate disclosures. Key points regarding these concepts in international accounting include:

1. **Ethical Considerations:** Ethical considerations in international accounting involve adhering to a set of moral principles and values that guide financial reporting practices. Ethical behavior is critical in maintaining trust and credibility in financial reporting.
2. **Sustainability Reporting:** Sustainability reporting goes beyond traditional financial reporting by including non-financial information related to a company's environmental, social, and governance (ESG) performance. It provides stakeholders with insights into a company's commitment to sustainable practices.
3. **International Accounting Standards:** International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) have evolved to incorporate ethical considerations and sustainability reporting through specific standards and guidance.
4. **Ethical Dilemmas:** International accounting standards address ethical dilemmas, such as revenue recognition, fair value measurement, and related party transactions, by providing principles and requirements that promote transparency and accountability.
5. **Sustainability Metrics:** International standards, such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB), offer frameworks for reporting on sustainability metrics, encouraging companies to disclose their environmental and social impacts.
6. **Integration with Financial Reporting:** Ethical considerations and sustainability reporting are increasingly integrated with financial reporting. This integration allows stakeholders to evaluate a company's financial performance in the context of its ethical behavior and sustainability initiatives.
7. **Stakeholder Expectations:** Investors, customers, regulators, and other stakeholders increasingly demand transparency and disclosure regarding a company's ESG practices. Ethical and sustainable behavior can influence investment decisions and reputation.
8. **Ethical Leadership:** Ethical leadership from top management is crucial in setting the tone for ethical conduct and sustainability initiatives within an organization. Ethical leaders prioritize ethical decision-making and sustainable practices.
9. **Materiality:** Sustainability reporting focuses on material issues that are relevant to a company's business and stakeholders, helping to prioritize the disclosure of information that matters most.
10. **Audit and Assurance:** Ethical considerations and sustainability reporting may also be subject to independent audit and assurance to verify the accuracy and completeness of disclosures.
11. **Regulatory and Market Trends:** Regulatory bodies and stock exchanges worldwide are introducing regulations and guidelines that promote sustainability reporting and ethical behavior, reflecting the growing importance of these factors.

Ethical considerations and sustainability reporting are integral to international accounting, as they promote transparency, accountability, and responsible corporate behavior. By disclosing non-financial information related to sustainability practices and adhering to ethical principles, companies can meet stakeholder expectations, enhance their reputation, and contribute to a more sustainable and ethical global business environment.

In response to global concerns about sustainability and corporate social responsibility, international accounting standards have evolved to include provisions for sustainability reporting. The scope of international accounting now encompasses the ethical considerations and environmental, social, and governance (ESG) factors that influence financial performance and long-term viability. Companies are increasingly expected to provide non-financial information alongside traditional financial statements, reflecting a broader scope of accountability.

4.10 Summary:

The scope of international accounting has evolved and expanded significantly to meet the challenges of an increasingly interconnected and globalized world. It encompasses a wide range of activities, from cross-border operations and consolidated reporting to regulatory compliance, financial instrument accounting, and sustainability reporting. As international accounting standards continue to evolve and converge, they play a critical role in promoting transparency, comparability, and investor confidence in global financial markets. In this era of globalization, the scope of international accounting is more crucial than ever in ensuring the accuracy and reliability of financial information for businesses, investors, and stakeholders worldwide.

4.11 Key words:

Financial instruments: A financial instrument is effectively a monetary contract (real or virtual) that confers a right or claim against some counterparty in the form of a payment equity ownership or dividends (stocks), debt (bonds, loans, deposit accounts), currency (forex), or derivatives (futures, forwards, options, and swaps). Financial instruments can be segmented by asset class and as cash-based, securities, or derivatives.

Business Combinations: A business combination is defined as an entity obtaining control of one or more businesses. The most common business combination is a purchase transaction in which the acquirer purchases the net assets or equity interests of a business for some combination of cash or shares.

Financial Disclosures: Financial and business interest disclosure refers to the system whereby one or more categories of public officials in a given country are required by law to disclose information about their assets and/or business activities.

Cost Allocation: Cost allocation is the process of identifying, aggregating, and assigning costs to cost objects. A cost object is any activity or item for which you want to separately measure costs. Examples of cost objects are a product, a research project, a customer, a sales region, and a department.

Sustainable Development Goals: The Sustainable Development Goals (SDGs) aim to transform our world. They are a call to action to end poverty and inequality, protect the planet, and ensure that all people enjoy health, justice and prosperity. It is critical that no one is left behind.

Auditor Scrutiny: An inspection, correction and verification of business accounts, conducted by an independent qualified accountant.

Ethical Leadership: Ethical leadership is leadership that is directed by respect for ethical beliefs and values and for the dignity and rights of others. It is thus related to concepts

such as trust, honesty, consideration, charisma and fairness. Ethics is concerned with the kinds of values and morals an individual or a society finds desirable or appropriate. Furthermore, ethics is concerned with the virtuousness of individuals and their motives. A leader's choices are also influenced by their moral development.

4.12 Self – assessment questions:

1. What is the scope of international accounting?
2. What are the items considering in financial accounting for IA?
3. Comment on 'Management accounting and IA'.
4. What is importance of IA in present days?
5. Write a note on accounting for complex financial instruments.
6. What are the ethical considerations in IA?

4.13 Further readings:

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7. K. R. Subramanyam and Kin Lo: International Financial Statement Analysis: Wiley
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Lesson – 5

FOREIGN CURRENCY TRANSACTIONS AND TRANSLATION

Learning objectives:

- ✓ To understand the concept of foreign currency transitions
- ✓ To know the various aspects in currency transactions
- ✓ To understand the benefits of currency transactions
- ✓ To understand the effects on risk management
- ✓ To understand the maintaining of foreign exchange accounting

Structure:

5.0 Introduction
5.1 Types of currencies
  5.1.1 Transactional currency
  5.1.2 Functional currency
  5.1.3 Reporting currency:
5.2 Currency transaction
5.3 Various aspects in foreign currency transactions
  5.3.1 Currency Exchange Rates
  5.3.2 Transaction Types
  5.3.3 Risk Management
  5.3.4 Hedging
  5.3.5 Impact on Financial Statements
  5.3.6 Regulatory Compliance
  5.3.7 Technological Advances
5.4 Initial measurement of foreign currency transactions
  5.4.1 Introduction to foreign exchange accounting
  5.4.2 Foreign currency transactions
5.5 Benefits of currency transactions
  5.5.1 International trade
  5.5.2 International tourism
  5.5.3 Global investment
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5.0 Introduction:

Today, we live in a world where the exchange of goods and services happens for money. This money is in the form of a particular currency. Now, the value of one currency will not be the same as that of another and this is where the need for foreign exchange arises. This is why Foreign Currency is the spine of international investments and global trading. Without it, it would be nearly impossible to determine the value of goods and services imported and exported by different countries to each other. And without having the possibility to trade, companies that rely on overseas resources and talent would be completely

crippled. Also, there would be major problems for foreign travellers to buy or sell anything while abroad thereby making foreign exchange so important.

5.1 Types of currencies:

To have clearer picture on foreign exchange accounting, the norm has classified currencies based on their business usage:

5.1.1 Transactional currency:

This is the currency in which payment is made. All the transactions are converted into the transactional currency for which payment is done.

5.1.2 Functional currency:

Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. 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.

5.1.3 Reporting currency:

This currency is used for entities' presentation of financial statements. This is used to compile transactions of all different currencies into one currency for easy and complete understanding.

Example: Consider an example of a company 'A' having basic operations carried in India and headquarter is in USA, making some business transactions in GBP. In this case, the Transactional currency is GBP (Great Britain Pound), Functional currency is INR (Indian Rupees) and Reporting currency is USD (US Dollars).

5.2 Currency transaction:

A foreign currency transaction is a transaction denominated in a currency other than an entity's functional currency. To include a foreign currency transaction in its financial statements, an entity must measure it in its functional currency.

Both a reporting entity and its distinct and separable operations may enter into foreign currency transactions. Foreign currency transactions of a distinct and separable operation should first be measured in its functional currency and then, if the operation is a foreign entity, translated into the reporting currency of its immediate parent.

When there is foreign currency transactions between members of a consolidated group that result in intercompany balances that are not considered to be of a long-term investment nature, the resulting transaction gain or loss survives consolidation even though the balance sheet accounts eliminate in consolidation.

Foreign currency transactions can be entered into by a reporting entity or its distinct and separable operations. For example, a subsidiary of a reporting entity with a functional currency of the US dollar may purchase inventory at a price denominated in euros, or a foreign entity with a Mexican peso functional currency may sell products in US dollars; each of these is a foreign currency transaction.

Some commonly occurring foreign currency transactions include:

- Revenue and accounts receivable arising from export sales.
- Expenses and accounts payable arising from the purchases of imported goods and the payment of wages in a foreign currency.
- Intercompany transactions.
- Investments in debt denominated in a foreign currency.
- Foreign currency denominated loans from financial institutions.
- Foreign bank accounts.
- Taxes imposed by foreign tax jurisdictions

When identifying foreign currency transactions, only the functional currency of the party that entered into the transaction should be considered; the functional currencies of the counterparty to the transaction and the reporting entity are irrelevant.

5.3 Various aspects in foreign currency transactions:

A foreign currency transaction refers to any financial exchange or transaction conducted using a currency that is not the domestic or base currency of the parties involved. In a globalized world, businesses, individuals, and governments engage in transactions with counterparts from different countries, necessitating the use of various currencies. These transactions encompass a wide array of activities, including trade, investment, tourism, remittances, and financial services. Key aspects of foreign currency transactions include:

5.3.1 Currency Exchange Rates:

Exchange rates determine the value of one currency in relation to another. They fluctuate based on economic, political, and market factors. The rate at which currencies are exchanged greatly influences the outcome of foreign currency transactions.

Currency exchange rates play a crucial role in currency transactions, influencing various aspects of international trade, investment, and financial markets. Here's a brief overview of their influence:

- **Transaction Value**: Exchange rates determine the value of one currency in relation to another. When converting one currency to another, the exchange rate directly impacts the amount of the target currency received for a given amount of the source currency.
- **Cost of Imports and Exports:** Exchange rates affect the cost of imports and exports. A strong domestic currency can make exports more expensive for foreign buyers, potentially reducing demand for domestic goods and services abroad. Conversely, a weaker domestic currency can make exports more competitive in international markets.
- **Inflation and Purchasing Power**: Changes in exchange rates can influence inflation rates by affecting the cost of imported goods and services. A depreciating currency can lead to higher import costs, potentially contributing to inflation. Conversely, an appreciating currency may help reduce inflation by making imports cheaper.
- **Investment Flows**: Investors consider exchange rates when making investment decisions, as these rates impact the value of their investments denominated in foreign currencies. Exchange rate fluctuations can lead to gains or losses on foreign investments when converted back to the investor's domestic currency.

- **Hedging and Risk Management:** Businesses engaged in international trade often use financial instruments like forward contracts or options to hedge against potential losses due to adverse exchange rate movements. This helps manage the risks associated with currency fluctuations.
- **Tourism and Travel**: Exchange rates influence the cost of traveling and tourism. A stronger domestic currency makes it cheaper for residents to travel abroad but more expensive for foreign tourists to visit the country, and vice versa.
- **Central Bank Policies**: Central banks often adjust interest rates and implement monetary policies to influence exchange rates. These policies can impact a country's competitiveness, trade balance, and overall economic stability.
- **Foreign Direct Investment (FDI):** Exchange rates influence FDI decisions. A favourable exchange rate can attract foreign investment by making the investment destination more financially attractive, potentially leading to increased capital inflows.

5.3.2 Transaction Types:

Foreign currency transactions can involve buying or selling goods, services, assets, or financial instruments denominated in a foreign currency. International trade, investment in foreign stocks, bonds, or real estate, and international travel expenses are common examples.Currency transactions involve the buying or selling of one currency for another and are central to international trade, finance, and investment. Here are the main types of currency transactions:

- **Spot Transactions**: Immediate exchange of one currency for another at the prevailing exchange rate, with settlement typically within two business days.
- **Forward Transactions:** An agreement to buy or sell a specific amount of currency at a predetermined exchange rate on a future date, beyond the standard two-day settlement of spot transactions.
- **Swap Transactions**: A combination of a spot transaction and a forward transaction, involving both an immediate exchange of currencies and a future re-exchange at an agreed-upon rate.
- **Currency Options**: Contracts that give the holder the right, but not the obligation, to buy (call option) or sell (put option) a specific amount of currency at a predetermined exchange rate before or at the options expiration date.
- **Currency Futures**: Standardized contracts to buy or sell a specified amount of currency at a future date at a predetermined exchange rate, traded on organized exchanges.
- **Cross Currency Transactions**: Transactions that involve the exchange of one currency for another without involving the U.S. dollar (e.g., EUR/JPY).
- **Foreign Exchange Swaps**: Simultaneous purchase or sale of a specified amount of a currency for spot delivery and a forward purchase or sale of the same amount of the same currency.

- **Currency Hedging Transactions**: Transactions undertaken to mitigate the risk of adverse exchange rate movements, often involving the use of forward contracts, options, or futures.
- **Traveller’s Currency Exchange**: Transactions where individuals exchange their domestic currency for the currency of the country they are visiting, typically done at airports, banks, or currency exchange offices.

- **Online Currency Transactions**: Exchange of currencies facilitated through online platforms or applications, allowing individuals and businesses to conduct transactions over the internet.
- **Central Bank Interventions**: Actions taken by a country's central bank to buy or sell its own currency in the foreign exchange market, aiming to influence exchange rates and stabilize the economy.

Understanding these various types of currency transactions is vital for businesses, investors, travellers, and financial institutions to effectively manage their exposure to exchange rate fluctuations and navigate the global financial landscape.

5.3.3 Risk Management:

Currency exchange rates are volatile and subject to change due to economic indicators, geopolitical events, interest rates, and market sentiments. Businesses and individuals engaged in foreign currency transactions employ risk management strategies to mitigate the impact of adverse exchange rate movements.

Risk management in the context of foreign exchange (forex) transactions involves strategies and measures employed by individuals, businesses, or financial institutions to mitigate the potential adverse effects of currency price fluctuations. These fluctuations can significantly impact financial outcomes, profitability, and overall stability. Here's a brief overview of risk management in foreign exchange transactions:

- **Identifying Risks**: Understanding and identifying the various risks associated with forex transactions, including exchange rate risk, interest rate risk, credit risk, liquidity risk, and geopolitical risk.
- **Exchange Rate Risk**: The primary risk in forex transactions, resulting from the unpredictable movements in exchange rates that can lead to financial losses or reduced profits.
- **Risk Assessment**: Evaluating the potential impact of currency rate fluctuations on the financial position and objectives of the organization, considering both short-term and long-term perspectives.
- **Hedging Strategies**: Utilizing financial instruments such as forward contracts, options, futures, and swaps to hedge against adverse exchange rate movements. Hedging helps lock in a specific exchange rate and provides protection against potential losses.
- **Diversification**: Spreading forex exposure across multiple currencies or geographic regions to reduce risk concentration and minimize the impact of adverse movements in any single currency.
- **Financial Derivatives**: Using financial instruments like currency options and futures to hedge against currency risk. Options provide flexibility to buy or sell at a specified price, while futures set a predetermined rate for future transactions.

- **Stop-Loss Orders**: Placing orders with a predetermined exchange rate to automatically execute a trade if the exchange rate reaches a specified unfavourable level, helping limit potential losses.
- **Forward Contracts**: Entering into forward contracts to fix the exchange rate for a future date, ensuring price certainty and reducing exposure to exchange rate fluctuations.

- **Constant Monitoring and Analysis**: Regularly monitoring forex markets, economic indicators, and geopolitical developments to anticipate potential currency movements and adjust risk management strategies accordingly.
- **Scenario Planning and Stress Testing**: Assessing the impact of extreme or adverse market conditions on the organization's forex positions to understand worst-case scenarios and develop appropriate risk mitigation strategies.
- **Compliance and Regulations**: Adhering to regulatory requirements and compliance standards related to forex transactions to mitigate legal and regulatory risks.

Effective risk management in foreign exchange transactions helps safeguard financial assets, ensures stability in financial performance, and supports strategic decision-making by reducing uncertainty and potential losses resulting from volatile currency markets.

5.3.4 Hedging:

Hedging involves using financial instruments like options, forwards, or futures to protect against potential losses resulting from unfavourable currency movements. It's a risk management tool widely utilized by businesses with international exposure.

Hedging in foreign currency transactions serves as a risk management strategy to mitigate the potential adverse effects of exchange rate fluctuations. It involves taking deliberate actions or using financial instruments to offset the risks associated with changes in currency values. The primary role of hedging in foreign currency transactions is to provide stability and predictability in financial outcomes. Here's a detailed explanation of its role:

- **Minimizing Exchange Rate Risk**: Hedging helps protect against losses resulting from unfavourable movements in exchange rates. By locking in an exchange rate through a financial instrument like a forward contract or an option, businesses can secure a known rate for future transactions, reducing uncertainty and risk.
- **Price Certainty and Planning**: Hedging provides a level of price certainty for future transactions involving foreign currencies. Businesses can accurately forecast costs, revenues, and profits, enabling better financial planning, budgeting, and decision-making.
- **Protecting Profit Margins**: Businesses often operate on tight profit margins, and fluctuations in exchange rates can erode these margins. Hedging allows businesses to protect their profit margins by securing favorable exchange rates for their transactions, even if the market rates move adversely.
- **Enhancing Cash Flow Predictability**: Cash flow is critical for businesses to meet their financial obligations. Hedging helps in managing cash flow by ensuring that the expected amounts from foreign transactions remain stable, allowing businesses to plan their cash flow requirements with greater accuracy.
- **Supporting International Trade and Investments**: For companies engaged in international trade or investments, hedging facilitates smoother transactions. It encourages and supports cross-border trade and investments by reducing the financial risks associated with dealing in multiple currencies.
- **Risk Diversification**: Hedging provides a way to diversify and manage risks associated with foreign currency exposure. By using a mix of financial instruments, businesses can spread their risk exposure and minimize the impact of adverse exchange rate movements.

- **Meeting Regulatory and Compliance Requirements**: Some industries and regions have regulatory requirements related to currency risk management. Hedging helps businesses comply with these regulations and industry standards.
- **Supporting Financial Stability and Investor Confidence**: Hedging activities can contribute to financial stability and enhance investor confidence. It demonstrates that a business is actively managing its financial risks, which can be reassuring to investors and stakeholders.
- **Aligning with Business Strategies:** Hedging allows businesses to align their foreign exchange risk management strategies with their overall business objectives, ensuring consistency and harmony between financial goals and risk mitigation efforts.

Hedging in foreign currency transactions plays a vital role in managing risks, providing stability, and enhancing financial performance. It enables businesses to navigate the complexities of the global market while safeguarding their financial position and profitability.

5.3.5 Impact on Financial Statements:

For multinational corporations, foreign currency transactions can impact financial statements due to changes in exchange rates. These changes can affect reported revenues, expenses, assets, liabilities, and ultimately the overall financial performance and position of the entity.

Foreign currency transactions can significantly impact a company's financial statements due to the exposure to exchange rate fluctuations. The effects are particularly relevant for multinational companies engaged in international trade, investment, or operations. Key areas where foreign currency transactions influence financial statements include:

- **Revenue and Expenses: Translation Impact**: Revenues and expenses denominated in foreign currencies need to be translated into the reporting currency (e.g., the company's domestic currency) for financial statement presentation. Fluctuating exchange rates can lead to variances in reported revenues and expenses.
- **Profit and Loss Statement: Gains/Losses from Foreign Exchange**: Fluctuations in exchange rates can result in gains or losses on foreign currency transactions, impacting the company's reported net income. For instance, a stronger domestic currency can lead to exchange rate losses on foreign payables, affecting net income negatively.
- **Cost of Goods Sold (COGS): Impact on COGS**: If a company imports goods and the domestic currency weakens, the cost of imported materials or products may increase, affecting the COGS and potentially reducing gross profit margins.
- **Balance Sheet: Assets and Liabilities Valuation**: Assets and liabilities denominated in foreign currencies are translated at the prevailing exchange rates at the balance sheet date, affecting their reported values. Exchange rate fluctuations can lead to changes in the reported value of foreign-currency-denominated assets and liabilities.

- **Equity and Comprehensive Income: Translation Adjustment**: The cumulative translation adjustment (CTA) is a component of other comprehensive income that captures the effects of translating foreign operations. It reflects the translation gain or loss resulting from changes in exchange rates on foreign currency financial statements.

- **Cash Flows: Impact on Cash Flow**: Exchange rate fluctuations can affect cash flows from operating, investing, and financing activities. For instance, cash flows from international sales or purchases can be affected by changes in exchange rates.
- **Financial Ratios and Performance Metrics: Impact on Ratios**: Key financial ratios such as profitability margins, return on investment, and debt ratios may be affected by changes in exchange rates, influencing how investors and analysts perceive the company's performance and financial health.
- **Income Tax: Tax Implications**: Foreign currency gains or losses may impact the calculation of taxable income and the associated tax liabilities. Tax treatment of foreign exchange gains and losses varies based on tax laws and regulations.

Understanding and appropriately disclosing the effects of foreign currency transactions on financial statements are crucial for providing transparent financial reporting. Companies often need to explain these impacts in footnotes or management discussions to ensure stakeholders can accurately interpret the financial information presented. Additionally, adhering to relevant accounting standards (e.g., International Financial Reporting Standards - IFRS or Generally Accepted Accounting Principles - GAAP) is essential for consistent and accurate reporting of these impacts.

5.3.6 Regulatory Compliance:

Different jurisdictions have specific regulations governing foreign currency transactions, particularly regarding reporting, taxation, and compliance with international financial standards. Adhering to these regulations is crucial to ensure legal and financial integrity.

Regulatory compliance in the context of currency transactions refers to adhering to laws, regulations, and guidelines set by governmental or regulatory authorities that govern how currency transactions are conducted. Compliance is essential to ensure transparency, legality, and ethical conduct in financial transactions, particularly in the realm of foreign exchange. The influence of regulatory compliance on currency transactions includes:

- **Anti-Money Laundering (AML) Laws**: Compliance with AML laws involves implementing measures to detect and prevent money laundering activities, which can be facilitated through currency transactions. Financial institutions and businesses must have robust AML policies and procedures in place to verify the identities of clients and report suspicious transactions to regulatory authorities.
- **Know Your Customer (KYC) Regulations: KYC** regulations require financial institutions to verify the identity of their customers before engaging in transactions. This includes gathering essential information about the customer's identity, address, and financial activities to mitigate the risk of fraudulent or illicit transactions.
- **Customer Due Diligence (CDD)**: CDD is a crucial aspect of regulatory compliance, ensuring that financial institutions understand their customers, their business activities, and the risks associated with their transactions. It involves ongoing monitoring of customer transactions to detect any unusual or suspicious activity.

- **Foreign Exchange Controls:** Many countries have regulations governing foreign exchange transactions, including restrictions on the amount of currency that can be bought or sold, reporting requirements, and approval processes. Compliance with these controls is essential to avoid legal issues and penalties.

- **Trade and Economic Sanctions**: Regulatory compliance involves adhering to international sanctions imposed on specific countries, entities, or individuals due to political, economic, or security reasons. Transactions involving sanctioned entities are strictly prohibited, and compliance requires screening transactions to ensure adherence to these sanctions.
- **Reporting Obligations**: Financial institutions and businesses engaged in currency transactions may have reporting obligations to regulatory authorities. These reports could include transaction reporting, suspicious activity reports, large cash transaction reports, and more.
- **Tax Compliance**: Currency transactions are often subject to taxation. Compliance involves accurately reporting and paying taxes on gains from currency transactions, whether it's from foreign exchange trading or currency conversions.
- **Financial Market Regulations**: Compliance with financial market regulations is critical for entities involved in currency transactions. Regulatory authorities establish rules governing the operation of financial markets, trading platforms, and brokers to ensure fair practices, market integrity, and investor protection.
- **Privacy and Data Protection Laws**: Compliance with privacy and data protection laws is essential when handling customer data related to currency transactions. Safeguarding personal information and ensuring data privacy is a fundamental aspect of regulatory compliance.

Adhering to these regulatory requirements is vital for maintaining the integrity of financial systems, preventing financial crimes, ensuring customer protection, and promoting a fair and transparent environment for currency transactions. Non-compliance can result in legal consequences, fines, reputational damage, and loss of business opportunities.

5.3.7 Technological Advances:

The advancement of technology and the rise of digital platforms have simplified foreign currency transactions. Online platforms and mobile apps provide real-time exchange rates and convenient ways to conduct transactions across borders.

Understanding and effectively managing foreign currency transactions are essential for individuals and businesses engaged in international activities. It involves careful consideration of exchange rates, risk mitigation strategies, compliance with regulations, and leveraging technology to facilitate seamless cross-border financial interactions.

5.4 Initial measurement of foreign currency transactions:

5.4.1 Introduction to foreign exchange accounting:

With businesses increasingly tapping foreign markets, there was a need to create guidelines on the treatment of revenue earned in foreign currency. Foreign Exchange Accounting covers the accounting of the transactions which are carried by a business in different currencies (Foreign currency) other than functional currency, and records such transactions in the functional currency of the reporting entity, based on the exchange rate in effect on the date of transaction. This also takes into picture any gains or losses that occur due to change in the expected exchange rate between the functional currency of the entity and the currency in which a transaction is denominated. The two situations in which business should not recognize a gain or loss on a foreign currency transaction are:

1. When a foreign currency transaction is designed to be an economic hedge of a net investment in a foreign entity, and is effective as such; or
2. When there is no expectation of settling a transaction between entities that are to be consolidated.

5.4.2 Foreign currency transactions:

The foreign exchange accounting gets initiated because of foreign currency transactions, so what is foreign currency transaction? Foreign currency transactions are the transactions denominated in any currency other than functional currency for that particular entity. These are converted into the functional currency at a later date.

5.4.2.1 Examples of these transactions are:

Revenue, Intercompany adjustments, Tax imposed by government etc.

Measuring of foreign currency transactions	
Monetary Assets and Liabilities	Non-Monetary Assets and Liabilities
Amount is fixed irrespective of future Prices. Example - Trade recevables, Cash, Long and Short term Investments, etc.	Amount determinable is based on the prices. Example - Inventory, Property.

Source: https://revgurus.com/knowledge-center-foreign-exchange-accounting/

5.4.2.2 Accounting entries: Monetary assets and liabilities:

XYZ Ltd, a UK based business sells goods to ABC Ltd, a US based business for $1,000 on 1st March 2018, when the exchange rate was £1 to $1.29.

Following entry will be passed in books.

	Debit	Credit
Account receivable	£775.1938	
To Sales		£775.1938

On 31st March 2018 Payment is made by ABC Ltd., exchange rate at this point of time was £1 to $1.35, due to which XYZ Ltd. suffered a loss of £34.4531. The following entry will be passed in the books.

	Debit	Credit
Cash/Bank	£740.7407	
Foreign currency exchange loss	£34.4531	
To Account receivable		£775.1938

5.4.2.3 non-monetary assets and liabilities:

XYZ Ltd buys plant and machinery from ABC Ltd for $5,000 when exchange rate was £1 to $1.29. Following entry to be passed.

	Debit	Credit
Plant & Machinery	£3875.969	
To XYZ Ltd.		£3875.969

After a month, when exchange rate moves to £1 to $1.25, payment is made by XYZ Ltd. to ABC Ltd. The following entry will be passed in the books.

	Debit	Credit
Cash/Bank	£4000	
To Plant and machinery		£3875.969
To Foreign exchange gain		£124.031

All the line item of the balance items are recalculated for closing the accounts and further translation gain and loses are to be calculated for the same. Later, when payments are made, then again gain and losses are calculated, and the accounts are adjusted accordingly.

5.5 Benefits of currency transactions:

In today's interconnected and globalized world, the need for foreign currency transactions has become an integral aspect of international trade, investment, travel, and financial operations. A foreign currency transaction involves exchanging one currency for another, enabling individuals, businesses, and governments to engage in cross-border activities. This essay explores the reasons why foreign currency transactions are essential and how they facilitate global interactions and economic growth.

5.5.1 International trade:

Foreign currency transactions are essential to facilitate international trade. Countries have diverse resources and capabilities, and engaging in trade allows them to optimize the allocation of these resources. For instance, a country may have a comparative advantage in producing certain goods due to its natural resources or skilled labour. Foreign currency transactions allow businesses to conduct trade by paying for imported goods or receiving payments for exported products in the respective currencies of the involved nations. This, in turn, promotes economic growth and prosperity by fostering mutually beneficial trade relationships.

5.5.2 International tourism:

Foreign currency transactions are indispensable for international travel and tourism. People travel for various reasons, such as leisure, business, or education, and often find themselves in foreign countries where the local currency is different from their own. Foreign currency transactions enable travellers to exchange their home currency for the currency of the destination country, ensuring that they can comfortably navigate and make purchases during their stay. Additionally, these transactions contribute to the economic development of the host country by boosting tourism-related businesses and generating revenue.

5.5.3 Global investment:

Foreign currency transactions play a critical role in global investments. Investors diversify their portfolios by investing in various countries and regions to spread risk and optimize returns. However, these investments necessitate the use of different currencies. Foreign currency transactions allow investors to convert their domestic currency into the required foreign currency for investment, facilitating global investment opportunities and

encouraging capital flow across borders. This influx of capital aids in economic development and stimulates growth in recipient nations.

5.5.4 Help to MNCs:

Foreign currency transactions are vital for conducting business operations seamlessly. Multinational corporations operate in multiple countries and deal with various currencies due to their global reach. They engage in transactions involving procurement, sales, and financial management in different currencies. Effective management of these transactions, including hedging against currency risks, is essential to safeguard the corporation's financial health and ensure stability across international operations.

5.5.5 Financial innovations:

Foreign currency transactions contribute to financial innovation and the advancement of technology. The development of foreign exchange markets, online platforms, and mobile applications has made currency exchange more efficient, transparent, and accessible. These technological advancements facilitate real-time monitoring of exchange rates, quicker transactions, and reduced transaction costs, promoting a more fluid global economy.

In conclusion, foreign currency transactions are a fundamental component of our interconnected world. They facilitate international trade, support travel and tourism, promote global investments, enable multinational corporations to operate seamlessly, and drive financial innovation. As globalization continues to evolve, understanding and effectively managing foreign currency transactions are imperative for individuals, businesses, and nations to navigate the complexities of the international landscape and foster economic growth and prosperity worldwide.

5.6 Summary:

Foreign currency transactions encompass a complex array of processes involving buying, selling, and exchanging currencies across international borders. Key aspects include currency exchange rates, forward contracts, options, and swaps, each serving unique purposes in risk management and financial strategy. These transactions facilitate global trade, investment, and economic growth by enabling businesses and individuals to engage in cross-border commerce with reduced risk of currency fluctuation. The benefits of foreign currency transactions lie in hedging against potential losses due to adverse exchange rate movements, enhancing liquidity, optimizing investment returns, and fostering international diversification. Additionally, these transactions facilitate access to a broader market, enable competitive pricing strategies, and support foreign direct investments. Overall, efficient management of foreign currency transactions is paramount for global economic stability, fostering smoother international transactions and promoting sustained financial growth.

5.7 Key words:

Transaction Value: This is the main method of assessment at customs. This is the price actually paid or payable for the goods when they are sold for export to the customs territory of the Union, adjusted, if applicable.

Investment Flows: An investment is an asset or item acquired with the goal of generating income or appreciation. Appreciation refers to an increase in the value of an asset over time. When an individual purchases a good as an investment, the intent is not to consume the good but rather to use it in the future to create wealth.

Foreign Direct Investment: Foreign direct investment (FDI) is an investment made by a company or an individual in one country into business interests located in another country. FDI is an important driver of economic growth.

Swaps: A swap is a derivative contract through which two parties exchange the cash flows or liabilities from two different financial instruments. Most swaps involve cash flows based on a notional principal amount such as a loan or bond, although the instrument can be almost anything. Usually, the principal does not change hands. Each cash flow comprises one leg of the swap. One cash flow is generally fixed, while the other is variable and based on a benchmark interest rate, floating currency exchange rate, or index price.

Financial Derivatives: Financial derivatives are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right. Transactions in financial derivatives should be treated as separate transactions rather than as integral parts of the value of underlying transactions to which they may be linked. The value of a financial derivative derives from the price of an underlying item, such as an asset or index. Unlike debt instruments, no principal amount is advanced to be repaid and no investment income accrues. Financial derivatives are used for a number of purposes including risk management, hedging, arbitrage between markets, and speculation.

KYC: KYC means to 'know your customer' which is an effective way for an institution to confirm and thereby verify the authenticity of a customer. For this, the customer is required to submit all KYC documentation before investing in various instruments. All financial institutions are mandated by the RBI to do the KYC process for all customers before giving them the right to carry out any financial transactions. Whether the customer uses KYC online verification or opts for offline KYC, this is a simple one-time process.

5.8 Self – assessment questions:

1. Write different types of currencies.
2. What you considered factors for currency exchange rate?
3. What are types of currency transactions?
4. Explain the concept of risk management with reference to currency exchange.
5. What are the objectives of hedging? How it uses in currency transaction?

5.9 Further readings:

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Dr. K. Sivaji

Lesson – 6
CURRENCY TRANSLATION

Learning objectives:
- ✓ To understand the process of currency translation
- ✓ To know the functioning of translation accounting
- ✓ To understand the various methods of currency translation
- ✓ To know the process of currency translation
- ✓ To understand the regulatory framework on this concept
- ✓ To able to identify the functional currency

Structure:

6.0 Introduction
6.1 Meaning of currency Translation
6.2 How Currency Translation Works
6.3 Methods of Currency Translation Accounting
 6.3.1 The current rate method
 6.3.2 The temporal method
6.4 Process of foreign currency translation
6.5 Translation Risk
6.6 Identification of functional currency
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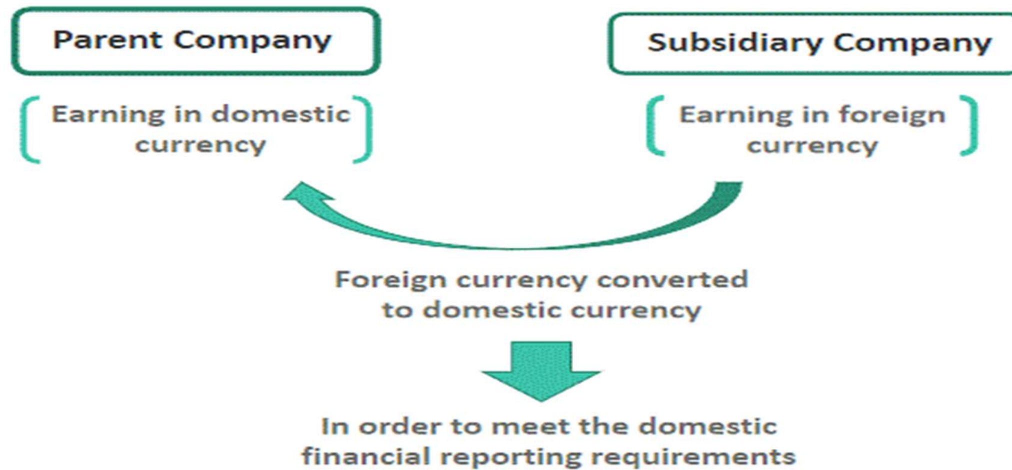
6.0 Introduction:

In order to consolidate or combine financial statements prepared in different currencies, a reporting entity must have financial statements of its foreign entities in its reporting currency to produce single currency, consolidated financial statements. This process is referred to as translation and is different than remeasuring foreign entity financial statements. A foreign entity remeasures its financial statements into its functional currency when its books and records are maintained in a currency other than its functional currency.

6.1 Meaning of currency Translation:

Currency translation is the process of converting one currency in terms of another, often in the context of the financial results of a parent company's foreign subsidiaries into its functional currency the currency of the primary economic environment in which an entity generates and expends cash flows.



Each foreign currency transaction, i.e. the assets, liabilities, gains or loss arising there from, is recorded in the reporting currency at the rate of exchange at the date of the transaction. At each balance sheet date, the monetary assets and liabilities (i.e. those to be received or paid in fixed ore determinable amounts of money) are translated at the exchange rate at the balance sheet date. In general, the resulting exchange gains and losses are dealt within the income statement.

Where an asset has been purchased in the last year, it was invoiced in a foreign currency, a liability arising on its acquisition cannot yet be settled and there is a severe devaluation of the currency of that liability against which there is no means of hedging then an Allowed Alternative Treatment is available. The devaluation exchange losses on that liability may be capitalized into the related asset (provided that it does not exceed its recoverable amount, or replacement cost if lower). These circumstances are expected to be rare. Equity investments in foreign entities (subsidiaries, associates, joint venture or branches) are not monetary assets and so are not retranslated. However, monetary items that in substance forms part of the net investment in the foreign entity, i.e. receivables and payables (other than trade items) for which settlement is neither planned nor likely for the foreseeable future, are retranslated but with the exchange differences taken directly to equity.

6.2 How Currency Translation Works:

Many companies, particularly big ones, are multinational, operating in various regions of the world that use different currencies. If a company sells into a foreign market and then sends payments back home, earnings must be reported in the currency of the place where the majority of cash is primarily earned and spent. Alternatively, in the rare case that a company has a foreign subsidiary, say in China, that does not transfer funds back to the parent company, the functional currency for that subsidiary would be the Chinese real.

Before a foreign entity's financial statements can translate into the reporting currency, the foreign unit's financial statements must be prepared in accordance with General Accepted Accounting Principles (GAAP) rules. When that condition is satisfied, the financial statements expressed in the functional currency should use the following exchange rates for translation:

- **Assets and liabilities**: The exchange rate between the functional currency and reporting currency at the end of the period.

- **Income Statement:** The exchange rates on the date that income or an expense was recognized; a weighted average rate during the period is acceptable.

- **Shareholder Equity:** The historical exchange rate at the date of entry to shareholder equity; the change in retained earnings uses historical exchange rates of each period's income statement.

- **Gains and losses** resulting from currency conversions are recorded in financial statements. The change in foreign currency translation is a component of accumulated other comprehensive income, presented in a company's consolidated statements of shareholders' equity and carried over to the consolidated balance sheet under shareholders' equity.

- **Footnotes:** If a company has operations abroad that keep books in a foreign currency, it will disclose the above methodology in its footnotes under "Note 1 - Summary of Significant Accounting Policies" or something substantially similar.

6.3 Methods of Currency Translation Accounting:

There are two main accounting standards for handling currency translation.

6.3.1 The current rate method:

Methods of foreign currency translation where most items are in the financial statements are translated at the current exchange rate. The current rate method is utilized in instances where the subsidiary isn't well integrated with the parent company, and the local currency where the subsidiary operates is the same as its functional currency.

The Current Rate Method (CRM) is an accounting method used for the translation of financial statements from a foreign currency to the reporting currency (usually the functional currency of the parent company) for consolidation purposes. This method is used in the context of multinational corporations that operate in multiple countries and have transactions denominated in various currencies. Here's a brief overview of the Current Rate Method:

1. **Functional Currency Determination**: Identify the functional currency of the foreign subsidiary, which is the primary currency in which the subsidiary conducts its business operations and generates cash flows.

2. **Translation at Current Exchange Rates:** Financial statements of the foreign subsidiary are translated into the reporting currency using the current exchange rates at the reporting date for balance sheet items and the average exchange rates for the period for income statement items.

3. **Exchange Rate Sources**: Exchange rates are obtained from reliable sources such as central banks, financial institutions, or other reputable sources. The rates used are typically spot rates or the rates prevailing at the reporting date.

4. **Translation of Balance Sheet Items**: Assets and liabilities on the balance sheet are translated at the closing exchange rates on the reporting date.

5. **Translation of Income Statement Items**: Revenues and expenses on the income statement are translated at average exchange rates for the period.

6. **Equity Items Translation**: Equity accounts (e.g., retained earnings, common stock) are translated at historical exchange rates or rates at the time of the transaction.

7. **Cumulative Translation Adjustment (CTA):** Any translation differences arising from the use of different exchange rates for translating various financial statement items are recorded as a separate line item in the consolidated equity section as a cumulative translation adjustment.

8. **Consolidation Process:** The translated financial statements of the foreign subsidiary are then consolidated with the financial statements of the parent company using the same currency.

9. **Reporting and Disclosures**: The consolidated financial statements are presented to stakeholders, accompanied by appropriate disclosures regarding the use of the Current Rate Method and the impact of currency translation on the financial results.

It's important to note that the Current Rate Method may result in translation gains or losses due to fluctuations in exchange rates, which can impact the reported financial results of the consolidated entity.

6.3.1.1 An example for current rate translation:

A simple example of using the Current Rate Method is to translate a foreign subsidiary's financial statements into the reporting currency. We'll use fictional amounts and exchange rates for this example.

Let's consider a foreign subsidiary operating in Europe with the euro (EUR) as its functional currency, and we need to translate its financial statements to the reporting currency, which is the US dollar (USD).

6.3.1.2 Assumption:

- Exchange rate at the reporting date (end of the period):
    - 1 EUR = 1.20 USD (current exchange rate)

6.3.1.3 Financial Statement Items (in EUR):

a. **Balance Sheet at Reporting Date:**
    - Cash: 50,000 EUR
    - Accounts Receivable: 30,000 EUR
    - Inventory: 20,000 EUR
    - Total Assets: 100,000 EUR
    - Accounts Payable: 15,000 EUR
    - Long-Term Debt: 40,000 EUR
    - Total Liabilities and Equity: 100,000 EUR

b. **Income Statement for the Period**:
    - Revenues: 120,000 EUR
    - Expenses: 80,000 EUR

- Net Income: 40,000 EUR
-

Using the current exchange rate of 1 EUR = 1.20 USD:

1. **Translation of Balance Sheet Items:**
    - Cash in USD: 50,000 EUR * 1.20 = 60,000 USD
    - Accounts Receivable in USD: 30,000 EUR * 1.20 = 36,000 USD
    - Inventory in USD: 20,000 EUR * 1.20 = 24,000 USD
    - Total Assets in USD: 100,000 EUR * 1.20 = 120,000 USD
    - Accounts Payable in USD: 15,000 EUR * 1.20 = 18,000 USD
    - Long-Term Debt in USD: 40,000 EUR * 1.20 = 48,000 USD
    - Total Liabilities and Equity in USD: 100,000 EUR * 1.20 = 120,000 USD

2. **Translation of Income Statement Items:**
    - Revenues in USD: 120,000 EUR * 1.20 = 144,000 USD
    - Expenses in USD: 80,000 EUR * 1.20 = 96,000 USD
    - Net Income in USD: 40,000 EUR * 1.20 = 48,000 USD

The translated financial statements in USD can then be used for consolidation and reporting purposes. Any translation differences (e.g., due to changes in exchange rates) would be recorded as a Cumulative Translation Adjustment (CTA) in the equity section.

6.3.2 The temporal method:

This method known as the historical method; this technique converts the currency of a foreign subsidiary into the currency of the parent company. The temporal method is used when the local currency of the subsidiary is not the same as the currency of the parent company. Differing exchange rates are used depending on the financial statement item being translated.

The Temporal Method is an accounting approach used to translate the financial statements of a foreign subsidiary from its functional currency to the reporting currency (usually the functional currency of the parent company) for consolidation purposes. This method is used when the foreign subsidiary's functional currency is different from the reporting currency.Here's a brief overview of the Temporal Method:

- **Functional Currency Determination**: Identify the functional currency of the foreign subsidiary, which is the primary currency in which the subsidiary conducts its business operations and generates cash flows. The functional currency is typically based on the economic environment in which the subsidiary operates.

- **Identification of Monetary and Non-Monetary Assets and Liabilities**: Classify assets and liabilities of the foreign subsidiary into monetary and non-monetary categories. Monetary items are those that are fixed in terms of units of currency and will be converted at the current exchange rate, while non-monetary items are translated at historical exchange rates.

- **Translation of Monetary Items**: Monetary assets and liabilities (e.g., cash, accounts receivable, accounts payable) are translated at the current exchange rate prevailing at the reporting date.

- **Translation of Non-Monetary Items**: Non-monetary items (e.g., inventory, property, plant, and equipment) are translated at historical exchange rates that were in effect at the time of the initial acquisition or recognition of the asset or liability.

- **Translation of Income Statement Items**: Revenue and expense items are translated at the average exchange rates for the period, except for certain expenses directly related to non-monetary assets (e.g., depreciation), which are translated at historical rates.

- **Equity Items Translation**: Equity accounts (e.g., retained earnings, common stock) are translated at historical exchange rates or rates at the time of the transaction.

- **Consolidation Process**: The translated financial statements of the foreign subsidiary are then consolidated with the financial statements of the parent company using the same currency.

- **Reporting and Disclosures**: The consolidated financial statements are presented to stakeholders, accompanied by appropriate disclosures regarding the use of the Temporal Method and the impact of currency translation on the financial results.

It's important to note that the Temporal Method may result in translation gains or losses due to fluctuations in exchange rates, which can impact the reported financial results of the consolidated entity.

6.3.2.1 An example for temporal method:

A simple example of using the Temporal Method to translate is a foreign subsidiary's financial statements into the reporting currency. We'll use fictional amounts and exchange rates for this example.

Let's consider a foreign subsidiary operating in Japan with the Japanese yen (JPY) as its functional currency, and we need to translate its financial statements to the reporting currency, which is the US dollar (USD).

6.3.2.2 Assumptions:

- Exchange rate at the reporting date (end of the period):
    1. 1 JPY = 0.009 USD (current exchange rate)
- Exchange rate at the acquisition date (historical rate):
    1. 1 JPY = 0.0085 USD (historical rate at acquisition)

Financial Statement Items (in JPY):

1. **Balance Sheet at Reporting Date**:
    - Cash (monetary): 10,000,000 JPY
    - Accounts Receivable (monetary): 8,000,000 JPY
    - Inventory (non-monetary): 5,000,000 JPY
    - Property, Plant, and Equipment (non-monetary): 30,000,000 JPY
    - Total Assets: 53,000,000 JPY
    - Accounts Payable (monetary): 7,000,000 JPY
    - Total Liabilities: 7,000,000 JPY
    - Common Stock (non-monetary): 40,000,000 JPY
    - Retained Earnings (non-monetary): 6,000,000 JPY

- Total Equity: 46,000,000 JPY
- Total Liabilities and Equity: 53,000,000 JPY

2. **Income Statement for the Period**:
    - Revenues (monetary): 35,000,000 JPY
    - Expenses (monetary): 25,000,000 JPY
    - Net Income: 10,000,000 JPY

6.3.2.3 Using the current exchange rate of 1 JPY = 0.009 USD:

1. **Translation of Monetary Balance Sheet Items:**
    - Cash in USD: 10,000,000 JPY * 0.009 USD/JPY = 90,000 USD
    - Accounts Receivable in USD: 8,000,000 JPY * 0.009 USD/JPY = 72,000 USD
    - Accounts Payable in USD: 7,000,000 JPY * 0.009 USD/JPY = 63,000 USD

2. **Translation of Non-Monetary Balance Sheet Items:**
    - Inventory in USD: 5,000,000 JPY * 0.0085 USD/JPY (historical rate) = 42,500 USD
    - Property, Plant, and Equipment in USD: 30,000,000 JPY * 0.0085 USD/JPY (historical rate) = 255,000 USD
    - Common Stock in USD: 40,000,000 JPY * 0.0085 USD/JPY (historical rate) = 340,000 USD
    - Retained Earnings in USD: 6,000,000 JPY * 0.0085 USD/JPY (historical rate) = 51,000 USD

3. **Translation of Income Statement Items**:
    - Revenues in USD: 35,000,000 JPY * 0.009 USD/JPY = 315,000 USD
    - Expenses in USD: 25,000,000 JPY * 0.009 USD/JPY = 225,000 USD
    - Net Income in USD: 10,000,000 JPY * 0.009 USD/JPY = 90,000 USD

The translated financial statements in USD can then be used for consolidation and reporting purposes. The translation of non-monetary items is based on the historical exchange rate at the time of acquisition, while monetary items are translated at the current exchange rate.

6.4 Process of foreign currency translation:

Foreign currency translation is the process of converting the financial statements of a foreign subsidiary or branch from its functional currency to the reporting currency of the parent company for consolidation and financial reporting. This process is crucial for multinational companies with operations in multiple countries and dealing with different currencies. Here's a step-by-step guide to the foreign currency translation process:

1. **Identify Functional Currency**: Determine the functional currency of the foreign entity. The functional currency is the primary currency in which the subsidiary operates and conducts its day-to-day business activities. It is usually the currency of the country where the entity is primarily located.

2. **Determine Reporting Currency**: Identify the reporting currency, which is the currency used for presenting consolidated financial statements at the group or parent

company level. The reporting currency is typically the currency in which the parent company's financial statements are prepared.

3. **Gather Financial Statements**: Collect the financial statements of the foreign subsidiary or branch, including the balance sheet, income statement, and any other relevant financial statements, in their functional currency.

4. **Choose Translation Method**: Select an appropriate translation method based on accounting standards and the circumstances of the foreign subsidiary. The two common methods are the Current Rate Method and the Temporal Method, each with its own set of rules for translation.

5. **Translate Balance Sheet Items**: For the Current Rate Method, translate balance sheet items (assets, liabilities, equity) using the exchange rates prevailing on the reporting date. For the Temporal Method, differentiate between monetary and non-monetary items and use appropriate historical or current exchange rates based on the type of item.

6. **Translate Income Statement Items**: Translate income statement items (revenues, expenses) using either average exchange rates for the period (Current Rate Method) or historical or current rates (Temporal Method) depending on the method selected.

7. **Translate Cash Flows (Optional):** If the statement of cash flows is required, translate the cash flows using appropriate exchange rates based on the selected translation method.

8. **Consolidate Translated Financials**: Combine the translated financial statements of the foreign entity with the parent company's financial statements, which are already in the reporting currency, for consolidation. Sum the individual line items to create consolidated financial statements.

9. **Record Translation Adjustments**: Calculate any translation adjustments resulting from differences in exchange rates between the acquisition date, transaction dates, and the reporting date. Record these adjustments in the consolidated financial statements, often in the equity section.

10. **Provide Disclosures**: Disclose the translation methods used, the exchange rates applied, and any translation adjustments in the notes to the consolidated financial statements to ensure transparency and compliance with accounting standards.

11. **Present Consolidated Financial Statements**: Present the final consolidated financial statements, which include the results of the foreign subsidiary translated into the reporting currency, to stakeholders, investors, and other relevant parties.

The accuracy and proper handling of foreign currency translation are vital for providing a comprehensive and accurate view of the financial position and performance of a multinational organization on a consolidated basis. It's important to adhere to applicable accounting standards and guidelines throughout this process.

6.5 Translation Risk:

Translation Risk is the exchange rate risk associated with companies that deal in foreign currencies and list foreign assets on their balance sheets.Companies that own assets in foreign countries, such as plants and equipment, must convert the value of those assets from the foreign currency to the home country's currency for accounting purposes. In the U.S., this accounting translation is typically done on a quarterly and annual basis. Translation risk results from how much the assets' value fluctuate based on exchange rate movements between the two counties involved.

Multinational corporations with international offices have the greatest exposure to translation risk. However, even companies that don't have offices overseas but sell products internationally are exposed to translation risk. If a company earns revenue in a foreign country, it must convert that revenue into its home or local currency when it reports its financials at the end of the quarter.

Translation risk, also known as accounting risk or currency translation risk, is the potential risk or exposure that a multinational company faces due to changes in foreign exchange rates during the process of translating financial statements denominated in a foreign currency to the reporting currency. This risk can affect the reported financial position, performance, and financial ratios of the company, impacting its overall financial health.Here are key points to understand about translation risk:

1. **Nature of Risk**: Translation risk arises from the fluctuation of exchange rates, which can impact the conversion of financial statements from a foreign subsidiary's functional currency to the reporting currency. Changes in exchange rates can affect the reported value of assets, liabilities, equity, revenues, expenses, and net income.

2. **Consolidated Financial Statements**: Multinational companies consolidate the financial statements of their foreign subsidiaries with those of the parent company to present a complete financial picture of the entire group. During this consolidation, financial statements in different currencies need to be translated, and translation risk comes into play.

3. **Financial Statement Impact**: Exchange rate changes can result in translation gains or losses, affecting the overall equity position and potentially misleading stakeholders. Fluctuations in foreign exchange rates can distort financial ratios, making it challenging for investors and analysts to accurately assess the company's performance and financial position.

4. **Volatility and Uncertainty**: Exchange rates are subject to market dynamics, geopolitical events, economic indicators, and monetary policies. The volatility and uncertainty surrounding exchange rates add to the complexity of managing translation risk. Sudden and significant changes in rates can have a substantial impact on financial statements.

5. **Hedging Strategies**: Multinational corporations often employ various hedging strategies to mitigate translation risk. These strategies may include forward contracts, options, swaps, and other financial instruments that help lock in exchange rates for future translations, providing a level of certainty in financial reporting.

6. **Importance of Risk Management**: Managing translation risk is crucial for multinational companies to present accurate and meaningful financial information to stakeholders. Effective risk management involves understanding the exposure, implementing appropriate hedging strategies, and regularly monitoring and evaluating the impact of exchange rate fluctuations.

7. **Regulatory Compliance and Disclosures**: Compliance with accounting standards (e.g., Generally Accepted Accounting Principles or International Financial Reporting Standards) necessitates appropriate disclosure of translation risk and its impact on the financial statements. Clear and transparent disclosures help stakeholders make informed decisions.

Translation risk is a significant consideration for multinational corporations due to the global nature of business operations. Understanding and effectively managing this risk is essential to present reliable financial information and maintain the integrity and credibility of financial reporting.

6.5.1 Example of Currency Translation:

International sales accounted for 64% of Apple Inc.'s revenue in the quarter ending Dec. 26, 2020.In recent years, a recurring theme for the iPhone maker and other big multinationals has been the adverse impact of a rising U.S. dollar. When the greenback strengthens against other currencies, it subsequently weighs on international financial figures once they are converted into U.S. dollars.

The likes of Apple seek to overcome adverse fluctuations in foreign exchange rates by hedging their exposure to currencies. Foreign exchange (forex) derivatives, such as future contracts and options, are acquired to enable companies to lock in a currency rate and ensure that it remains the same over a specified period of time.

6.6 Identification of functional currency:

Identification of the functional currency is not subject to definitive criteria. Certain basic economic factors should be considered in making this identification. Consider:

Indicator	Foreign Subsidiary's Currency as Functional Currency	Parent's Currency as Functional Currency
Cash flows	Cash flows are primarily in the foreigncurrency. Such flows do not impact theparent's cash flows.	Cash flows directly impactthe parent's cash flows andare readily available to theparent.
Sales price	Sales prices are influenced by local factorsrather than exchange rates.	Sales prices are influencedby international factors.
Sales market	There is an active and primarily localmarket.	The sales market is mainlyin the parent's country.
Expenses	Goods and services are acquired locallyand denominated in local currencies.	Goods and services areacquired from theparent's country.
Financing	Financing is secured locally and denominatedin local currencies. Debt is serviced throughlocal	Financing is securedmainly from the parent or isdenominated in theparent's

	operations.	currency.
Intercompany trans.	Intercompany transactions are few. Majorinterrelationships between foreign andparent operations do not exist.	Intercompany business ishigh. There are majorinterrelationships betweenentities. Foreign entityholds major assets andobligations of parent.

These factors should be considered individually and collectively in order to identify the functional currency. Remember that the functional currency may be one other than that of the foreign entity or the parent.

6.7 RBI guidelines for foreign currency transactions:

The Reserve Bank of India (RBI) governs and regulates foreign currency transactions through various guidelines and regulations. These guidelines are subject to change, so it's important to refer to the latest updates and directly consult the RBI or relevant financial authorities for the most current and accurate information. Here's a general overview of the RBI guidelines on foreign currency transactions:

1. **Authorized Dealers (ADs):** RBI has authorized specific banks and financial institutions as ADs to handle foreign exchange transactions. Individuals and businesses must conduct foreign currency transactions through these authorized entities.

2. **Foreign Exchange Management Act (FEMA):** The Foreign Exchange Management Act (FEMA) is a crucial piece of legislation in India that governs foreign exchange transactions and external trade. Enacted in 1999, FEMA replaced the earlier Foreign Exchange Regulation Act (FERA) and aimed at liberalizing foreign exchange control. FEMA facilitates foreign trade, investments, and payments while enforcing compliance through authorized dealers and regulatory mechanisms. It regulates activities such as foreign investments, external commercial borrowings, and remittances to maintain the stability of the country's external trade and payments. FEMA empowers the Reserve Bank of India (RBI) to frame rules and guidelines to govern foreign exchange transactions, ensuring transparency, efficiency, and compliance with international best practices. Adherence to FEMA is mandatory for individuals, businesses, and financial institutions engaged in any foreign exchange activities. Violations of FEMA provisions can result in penalties and legal consequences. Overall, FEMA plays a critical role in managing India's foreign exchange reserves and facilitating international transactions in a structured and controlled manner.

3. **Foreign Exchange Transactions**: RBI sets rules and regulations governing various foreign exchange transactions, such as foreign remittances, trade credits, imports, exports, and investments in foreign securities, among others. Entities engaging in such transactions need to comply with the prescribed procedures and limits.

4. **Exchange Control Manual**: The RBI publishes an Exchange Control Manual that provides comprehensive guidelines and procedures for foreign exchange transactions, covering a wide range of transactions and scenarios.

5. **Know Your Customer (KYC) Norms:** KYC, or Know Your Customer, is a vital process that financial institutions and banks employ to verify the identity and gather

essential information about their clients or customers. This process is crucial for various financial transactions, including those involving foreign currency. When it comes to foreign currency transactions, KYC helps ensure compliance with regulatory requirements and the prevention of money laundering, fraud, and other financial crimes.

For foreign currency transactions, banks and authorized dealers collect and verify specific identification and financial details from customers before conducting transactions. This includes valid identification documents, proof of residence, and information about the source of funds. The aim is to ascertain the legitimacy and legality of the funds being used for the transaction.Here are key aspects of KYC in the context of foreign currency transactions:

- **Verification of Identity**: Customers are required to provide valid identification documents such as passports, national IDs, or other government-issued IDs to prove their identity. This verification ensures that the person engaging in the foreign currency transaction is legitimate.

- **Proof of Residence**: Proof of residence, such as utility bills or bank statements, is often needed to establish the customer's address. This helps in validating the customer's residential details and is a crucial component of the KYC process.

- **Source of Funds**: Customers are asked to provide information about the source of funds being used in the foreign currency transaction. This helps in ensuring that the funds are obtained legally and are not associated with illegal activities.

- **Customer Due Diligence (CDD):** CDD is an integral part of the KYC process, involving assessing the risks associated with a customer and their transactions. Financial institutions determine the level of due diligence required based on the customer's risk profile.

- **Periodic Updating of Information**: Financial institutions often require customers to update their KYC information periodically. This helps ensure that the customer's details remain accurate and up-to-date.

- **Enhanced Due Diligence (EDD):** In cases where higher risks are identified, such as large transactions or those involving politically exposed persons (PEPs), enhanced due diligence is conducted to gather additional information for a more thorough risk assessment.

6. **Liberalized Remittance Scheme (LRS):** RBI has established the LRS, allowing individuals to remit a certain amount of money in a financial year for permitted current and capital account transactions, including investments in shares, securities, and properties outside India.

7. **Foreign Direct Investment (FDI) Guidelines**: RBI prescribes guidelines and regulations for foreign direct investments in India. It covers sectoral caps, reporting requirements, and other procedural aspects for both inbound and outbound investments.

8. **External Commercial Borrowings (ECB):** RBI regulates borrowing by Indian entities from non-resident sources, known as ECBs. It sets conditions, terms, and eligibility criteria for such borrowings to ensure prudential borrowing and repayment.

9. **Foreign Exchange Reserve Management**: RBI actively manages the country's foreign exchange reserves to ensure stability in the foreign exchange market and meet the nation's international payment obligations.

10. **Reporting and Compliance**: Entities engaging in foreign exchange transactions are required to submit periodic reports to the RBI or other designated authorities, ensuring compliance with regulatory norms and guidelines.

It's essential for individuals and businesses involved in foreign exchange transactions to stay informed about the latest RBI guidelines and comply with the prescribed regulations to ensure legal and smooth transactions. For the most up-to-date and detailed guidelines, individuals and entities should refer directly to the RBI's official website or contact authorized dealers.

6.8 Summery:

In conclusion, foreign currency translation in accounting involves the conversion of financial statements from one currency to another, a crucial task for multinational corporations. Key aspects encompass the use of exchange rates, the treatment of gains and losses due to currency fluctuations, and compliance with accounting standards like International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). Various methods like the current rate method, temporal method, and monetary/non-monetary method are employed to achieve accurate and consistent financial reporting across multiple currencies. Each method comes with its own set of advantages and limitations, necessitating a careful selection based on the nature of transactions and economic environment. The choice of method significantly impacts financial statements, affecting profitability, equity, and overall financial health, making precision and adherence to accounting standards imperative in foreign currency translation.

6.9 Key words:

GAAP: Generally accepted accounting principles (GAAP) refer to a common set of accounting rules, standards, and procedures issued by the financial accounting standards board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements. GAAP is guided by ten key tenets and is a rules-based set of standards. It is often compared with the international financial reporting standards (IFRS), which is considered more of a principles-based standard. IFRS is a more international standard, and there have been recent efforts to transition GAAP reporting to IFRS.

Exchange Rate: Foreign Exchange Rate is defined as the price of the domestic currency with respect to another currency. The purpose of foreign exchange is to compare one currency with another for showing their relative values. Foreign exchange rate can also be said to be the rate at which one currency is exchanged with another or it can be said as the price of one currency that is stated in terms of another currency. Exchange rates of a currency can be either fixed or floating. Fixed exchange rate is determined by the central

bank of the country while the floating rate is determined by the dynamics of market demand and supply.

Functional currency: The term functional currency represents the currency of the location in which the business operates primarily, earns a significant portion of revenue, and incurs the cost to generate the same revenue. We can also say that it is the country's home currency where the headquarters of the business is situated.

Translation Risk: Translation risk is the exchange rate risk associated with companies that deal in foreign currencies and list foreign assets on their balance sheets. Companies with assets in foreign countries must convert the value of those assets from the foreign currency to the home country's currency.

6.10 Self – assessment questions:

1. How currency translation works?
2. Write a note on current rate method.
3. Brief the temporal technique of currency translation.
4. What is the process of foreign currency translation?
5. What is translation risk? Narrate its key points.
6. What is RBI guideline for foreign currency transactions?

6.11 Further readings:

1. C. J. Date, "An Introduction to Database Systems" – Pearson
2. Warren J. Keegan and Mark C. Green, "Global Marketing" – Pearson
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6. Dr. H. R. Machiraju, "Financial Derivatives: Theory, Concepts and Problems" - Himalaya Publishing House
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8. Dr. S. Gurusamy, "International Financial Management" - McGraw Hill Education
9. Dr. Prasanna Chandra, "Financial Management: Theory and Practice" - McGraw Hill Education
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Lesson – 7

FORWARD CURRENCY TRANSLATIONS

Learning objectives:

- ✓ To understand the concept of forward contracts
- ✓ To understand the transactions on forward currency
- ✓ To know the differences between forward and future contracts
- ✓ To understand the functioning of froward currency translations
- ✓ To understand the risk in these transactions

Structure:

7.0 Introduction
7.1 What is a Forward Contract
7.2 What Is a Currency Forward?
7.3 Understanding Currency Forwards
7.4 What are forward Contracts used for?
  7.4.1 Speculation
  7.4.2 Hedging
7.5 How Do Currency Forwards Work?
  7.5.1 Example of a Currency Forward
7.6 Forward Markets Commission
7.7 Foreign Exchange (FX) Accounting
7.8 Exchange Rates and Conversion
  7.8.1 Functional Currency
  7.8.2 Transaction Exposure
7.9 Transaction exposure and risk management
  7.9.1 Translation Exposure
  7.9.2 Forward Contracts and Hedging
  7.9.3 Recording Foreign Exchange Gains and Losses
  7.9.4 Financial Statement Reporting
  7.9.5 Compliance and Accounting Standards
  7.9.6 Risk Management and Strategy
7.10 Accounting standard for currency translation
  7.10.1 Scope of IAS 21: IAS 21 deals with how to
  7.10.2 Not in the scope of IAS 21
  7.10.3 Key definitions
7.11 Functional currency versus presentation currency:
  7.11.1 Determining functional currency is not always straight forward
  7.11.2 Example 1
  7.11.3 Example 2
7.12 Initial recognition of foreign currency transactions
7.13 Subsequent recognition - monetary items
  7.13.1 What are monetary items?
  7.13.2 Subsequent recognition - non-monetary items
  7.13.3 Where is the exchange difference recognised?
7.14 Net investment in a foreign operation
7.15 What if an entity changes its functional currency?
7.16 Presentation currency is different to the functional currency

7.17 Translating results and financial position of foreign operations
7.18 Disposals or partial disposals of foreign operations
7.19 Foreign currency cash flows in the cash flow statement
7.20 Over the Counter Traded Forwards
7.21 The Forward Market vs. the Futures Market
7.22 Futures Contract Definition
    7.22.1 Exchange Traded Futures
7.23 Difference between Forward Market and Futures Market
7.24 Summery
7.25 Key words
7.26 Self – assessment questions
7.27 Further readings

7.0Introduction:

This part of lesson is a comprehensive exploration of vital aspects related to managing financial risks and transactions in the realm of international currency exchange. In this session, we will delve into the intricacies of currency forward contracts, the implications of transaction exposure risk, adherence to relevant accounting standards, and the strategic utilization of future contracts. Understanding these fundamental elements is essential for businesses and financial professionals navigating the complex landscape of global trade and finance. Let's embark on this enlightening journey to gain a thorough understanding of forward currency translations and equip ourselves with the knowledge to make informed decisions in this dynamic and interconnected global economy.

7.1 What is a Forward Contract?

What is traded in the forward market is forward contracts. These are contracts under which one party will agree to sell a set quantity of something for a set price at a certain point in the future. They are used to lock in the price of a trade that will take place in the future. After a forward trade is agreed to, both sides are committed to completing the exchange that they have arranged. If, when the time comes to complete the exchange, the current market rate for whatever is being traded has changed, this will not have an effect on the deal. The agreed exchange will take place, nonetheless.

7.2 What Is a Currency Forward?

A currency forward is a binding contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on a future date. A currency forward is essentially a customizable hedging tool that does not involve an upfront margin payment. The other major benefit of a currency forward is that its terms are not standardized and can be tailored to a particular amount and for any maturity or delivery period, unlike exchange-traded currency futures.

7.3 Understanding Currency Forwards:

Unlike other hedging mechanisms such as currency futures and options contracts which require an upfront payment for margin requirements and premium payments, respectively currency forwards typically do not require an upfront payment when used by large corporations and banks.

However, a currency forward has little flexibility and represents a binding obligation, which means that the contract buyer or seller cannot walk away if the “locked-in” rate eventually proves to be adverse. Therefore, to compensate for the risk of non-delivery or non-

settlement, financial institutions that deal in currency forwards may require a deposit from retail investors or smaller firms with whom they do not have a business relationship.

Currency forward settlement can either be on a cash or a delivery basis, provided that the option is mutually acceptable and has been specified beforehand in the contract. Currency forwards are over – the – counter (OTC) instruments, as they do not trade on a centralized exchange, and are also known as "outright forwards."

7.4 What are forward Contracts used for?

Forward contracts can be used for speculation, where risk is taken with the intention of making a profit. However, ironically, they can also be used for hedging purposes. This is where they allow risk to be avoided.

7.4.1 Speculation

The most obvious use for forward trades is speculation. If someone is able to correctly predict how the price of something that is traded in a forward trade will change over time, they will be able to benefit as a result.

If, using a commodity forward trade, for example, a speculator is able to buy a commodity at below the market rate in the future they will be able to profit from the price disparity between the forward trade price and the future current market rate.

Say a trader takes out a forward trade to buy a certain quantity of coffee for a certain price at a certain time in the future, they will benefit if the price of coffee increases in the meantime. If the price of coffee does increase between the time, they take out the forward trade and the time they complete it, they will make a profit. The forward contract will guarantee them the right to buy low and they will be able then to sell high at the market rate for a profit. Obviously, the trader will be taking the risk that the price of coffee could fall in the meantime.

7.4.2 Hedging

What is less immediately obvious is that forward trades can be used to avoid risk. Forward trades provide a hedge against risk by providing an alternative to waiting to trade something at the current market rate in the future.

If someone is forced to wait to trade something at whatever the current market rate turns out to be in the future, there is a risk that the price will change adversely. Going back to the example of coffee prices, we can see how a forward trade could be used to avoid risk.

Say the seller in our example contract was a coffee producer, they may be using the forward contract to guarantee a profitable price. If they knew that the price set out in the forward contract guaranteed them a good profit, they may opt to take the forward trade rather than risk a loss. While they would not be able to take advantage if prices rose, they would still be guaranteed a profit and would avoid risking what could otherwise be a loss.

7.5 How Do Currency Forwards Work?

Currency forwards work in the same way as all other forward trades do. It is just that what is being traded in a currency forward is currencies.

Under a currency forward contract, two parties will agree to exchange a set amount of two currencies at a set rate on or before a future date. One party will sell a set amount of one currency for a set amount of a different currency on or before an agreed date in the future. What this does is fix the exchange rate for an exchange of currencies in advance.

As with other forward trades, currency forwards can be used for speculation and for hedging. When used in speculation, a currency trader will look to either buy a currency low or sell it high in the future.

7.5.1 Example of a Currency Forward:

The mechanism for computing a currency forward rate is straightforward, and depends on interest rate differentials for the currency pair (assuming both currencies are freely traded on the forex market).

For example, assume a current spot rate for the Canadian dollar of US$1 = C$1.0500, a one-year interest rate for Canadian dollars of 3 percent, and the one-year interest rate for US dollars of 1.5 percent.

After one year, based on interest rate parity, US$1 plus interest at 1.5 percent would be equivalent to C$1.0500 plus interest at 3 percent, meaning:

$1 (1 + 0.015) = C$1.0500 x (1 + 0.03)
US$1.015 = C$1.0815, or US$1 = C$1.0655

The one-year forward rate in this instance is thus US$ = C$1.0655. Note that because the Canadian dollar has a higher interest rate than the US dollar, it trades at a forward discount to the greenback. As well, the actual spot rate of the Canadian dollar one year from now has no correlation on the one-year forward rate at present.

The currency forward rate is merely based on interest rate differentials and does not incorporate investors' expectations of where the actual exchange rate may be in the future.

7.6 Forward Markets Commission:

The Forward Markets Commission (FMC) is a regulatory body for monitoring futures and commodities market in India. FMC is fully controlled by the Securities and Exchange Board of India (SEBI) under the Ministry of Finance. The Forward Markets Commission was established in 1953 and is headquartered in Mumbai, Maharashtra.

FMC controls the regulatory side of the Indian forward market. Presently, five (5) national exchanges, including Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), Indian Commodity Exchange Ltd (ICEX), National Multi Commodity Exchange (NMCE), and ACE Derivatives and Commodity Exchange, facilitates forward trading in over 110 commodities in India. Moreover, sixteen (16) other commodity exchanges regulate trades in many commodities specified in the Forward Contracts (Regulation) Act, 1952.

7.7 Foreign Exchange (FX) Accounting:

Foreign exchange accounting for foreign exchange involves recording transactions conducted in other than the functional currency and adjusting them for changes in foreign

exchange rates. FX accounting includes the translation of foreign entity financial statements into their parent company's functional currency during consolidation.

Numerous entities transact with foreign entities or have subsidiaries and /or operations in foreign jurisdictions and are thus exposed to foreign exchange transactions. In addition, some entities are required to or elect to report in a presentation currency that is different to their functional currency. The following is explained that how an entity is required to account for such foreign exchange transactions.

Foreign exchange accounting involves the processes and procedures used by businesses to record and manage transactions denominated in foreign currencies. It's a crucial aspect for companies engaged in international trade or with operations in multiple countries. Proper foreign exchange accounting ensures accurate financial reporting and helps mitigate the risks associated with currency fluctuations.Some aspects of foreign exchange accounting:

7.8 Exchange Rates and Conversion:

Exchange rates determine the value of one currency relative to another. Businesses need to determine the appropriate exchange rate to convert foreign currency transactions into their reporting currency (often the company's functional currency) for financial statement purposes.

7.8.1 Functional Currency:

The functional currency is the primary currency used in a business's operations and financial reporting. For multinational companies, the functional currency is typically the currency of the country where the primary economic activities are conducted.

7.8.2 Transaction Exposure:

Businesses face transaction exposure when they engage in transactions denominated in a foreign currency. Changes in exchange rates can impact the cost of goods, revenue, and expenses. To manage this risk, companies may use various hedging strategies.

Transaction exposure in the context of foreign currency transactions refers to the risk that changes in exchange rates between the transaction date and the settlement date will affect the value of a specific transaction denominated in a foreign currency. Businesses that engage in international trade or have cross-border transactions are exposed to this risk. Transaction exposure can have significant implications for a company's financial performance and profitability. Here are key points about transaction exposure in foreign currency transactions:

A. **Nature of Transaction Exposure**: Transaction exposure arises when a company has cash flows, receivables, payables, or other financial instruments denominated in foreign currencies. Fluctuations in exchange rates can impact the amount of the domestic currency the company will ultimately receive or pay.

B. **Impact on Cash Flows**: Exchange rate movements can affect the actual cash flows related to a transaction. If the domestic currency strengthens against the foreign currency, it may reduce the cash inflows in terms of the domestic currency for receivables or increase the cash outflows for payables. Businesses employ various strategies to mitigate transaction exposure. These include hedging through forward contracts, options, or other financial derivatives to lock in exchange rates for future transactions, providing a level of certainty in cash flows.

C. **Common views**: One common hedging tool is a forward contract, where the company agrees to buy or sell a specific amount of a foreign currency at a predetermined exchange rate at a future date. This helps protect against adverse exchange rate movements. Options give the holder the right, but not the obligation, to buy or sell a foreign currency at a specified exchange rate within a set period. Companies can use options to hedge against unfavourable exchange rate changes while still benefiting from favourable movements.

D. **Risk Assessment and Monitoring**: Businesses must continually assess their exposure to transaction risk and regularly monitor the foreign exchange market to identify potential risks and opportunities. This allows for timely adjustments to hedging strategies.

E. **Global Economic Factors**: Transaction exposure can be influenced by global economic conditions, interest rate changes, geopolitical events, and market sentiment, all of which can impact exchange rates and subsequently transaction outcomes.

7.9 Transaction exposure and risk management:

Transaction exposure in foreign currency transactions poses a potential risk to businesses. Implementing effective risk management strategies, such as hedging through financial derivatives or natural hedging techniques, is essential for mitigating these risks and maintaining financial stability and predictability in a global business environment.

7.9.1 Translation Exposure:

Translation exposure arises when a company has foreign subsidiaries or investments, and their financial statements need to be translated into the reporting currency for consolidation. Exchange rate changes can affect the translated value of assets, liabilities, and equity, impacting the overall financial position.

7.9.2 Forward Contracts and Hedging:

Businesses often use forward contracts or other financial instruments to hedge against the risk of adverse exchange rate movements. These instruments allow them to lock in exchange rates for future transactions, providing a level of certainty in financial planning.

7.9.3 Recording Foreign Exchange Gains and Losses:

Foreign exchange gains and losses arise due to changes in exchange rates between the transaction date and the settlement date. These gains and losses are recorded in the financial statements and can impact the company's reported profits and overall financial position.

7.9.4 Financial Statement Reporting:

Foreign currency transactions and balances are reported in the financial statements using the relevant exchange rates at the time of the transactions. Exchange rate differences are recorded in income statements or comprehensive income, depending on the accounting standards followed.

7.9.5 Compliance and Accounting Standards:

Compliance with applicable accounting standards, such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP), is

essential in foreign exchange accounting to ensure consistency and comparability in financial reporting.

7.9.6 Risk Management and Strategy:

Effective foreign exchange accounting involves developing a clear strategy for managing currency risk, considering the company's exposure, risk tolerance, and market conditions. This may involve collaborating with financial experts or employing risk management software.

Foreign exchange accounting is a critical discipline that helps businesses accurately account for and manage the impact of currency fluctuations on their financial performance and position, ultimately contributing to informed decision-making and financial stability.

7.10 Accounting standard for currency translation:

IAS 21 The effects of changes in foreign exchange rates are the Accounting Standard that describes the requirements when accounting for foreign exchange transactions in a non-hyperinflationary economy. There are various interpretations that deal with specific aspects of foreign currency translation, but this article focuses on the basics of IAS 21. (Accounting for transactions in a hyperinflationary economy are accounted for under a different standard and are not addressed in this article.)

7.10.1 Scope of IAS 21: IAS 21 deals with how to:

- Account for transactions and balances undertaken by an entity in foreign currencies (except for derivatives accounted for under IFRS 9 Financial Instruments).

- Translate the results and financial position of foreign operations that have a different functional currency to the entity.

- Translate the entity's results and financial position into a presentation currency different to its functional currency.

7.10.2 Not in the scope of IAS 21:

IAS 21 does not apply to hedge accounting for foreign currency items, and it also does not apply to hedging a net investment in a foreign operation.

7.10.3 Key definitions:

IAS 21 uses the following definitions, so it is important to understand what they mean before delving into the detailed accounting requirements.

Term	Definition
Closing rate	Spot exchange rate at the end of the reporting period
Exchange difference	Difference resulting from translating a given number of units of one currency into another currency at different exchange rates
Exchange rate	Ratio of exchange for two currencies
Foreign currency	Currency other than the functional currency of the entity

Foreign operation	An entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity
Functional currency	Currency of the primary economic environment in which the entity operates
Monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency
Net investment ina foreign operation	Amount of the reporting entity's interest in the net assets of that operation
Presentation currency	Currency in which the financial statements are presented
Spot exchange rate	Exchange rate for immediate delivery

7.11 Functional currency versus presentation currency:

When preparing general purpose financial statements, it is important to understand the difference between your entity's 'functional currency' and its 'presentation currency'.An entity **measures** transactions and balances in its financial statements using the **functional currency**, which is the currency of the primary economic environment in which the entity operates. The **presentation currency** is the currency used when presenting the financial statements.

For example, a New Zealand entity that mainly does business in New Zealand, and mainly transacts in New Zealand dollars, will have a New Zealand dollar functional currency, and will usually also have a New Zealand dollar presentation currency. However, it may choose a different presentation currency if desired (IAS 21.18 and 19).

7.11.1 Determining functional currency is not always straight forward:

It is not always easy to determine an entity's functional currency because it may transact in several currencies. However, IAS 21, paragraphs 9-11, include a hierarchy of indicators to help entities decide on the appropriate functional currency. These indicators are:

Step 1 – Consider the primary economic environment indicators (IAS 21.9)
Step 2 – Consider additional supporting indicators (IAS 21.10)
Step 3 – When indicators are mixed, **use judgement**.

7.11.2 Example 1:

A New Zealand parent company has the majority of its revenue earning activity being by way of dividends received from its overseas subsidiaries. It is very unlikely to have a New Zealand dollar (NZD) functional currency, even though it raises funding from New Zealand investors.

7.11.3 Example 2:

Mining Co is listed in New Zealand and has a gold mine in South Africa. The South African workforce is paid in South African Rands and capital equipment is purchased in US dollars. The gold produced by the mine is sold in US dollars. Mining Co is financed by loans in New Zealand dollars, it incurs listing fees in New Zealand and pays its directors in New Zealand.

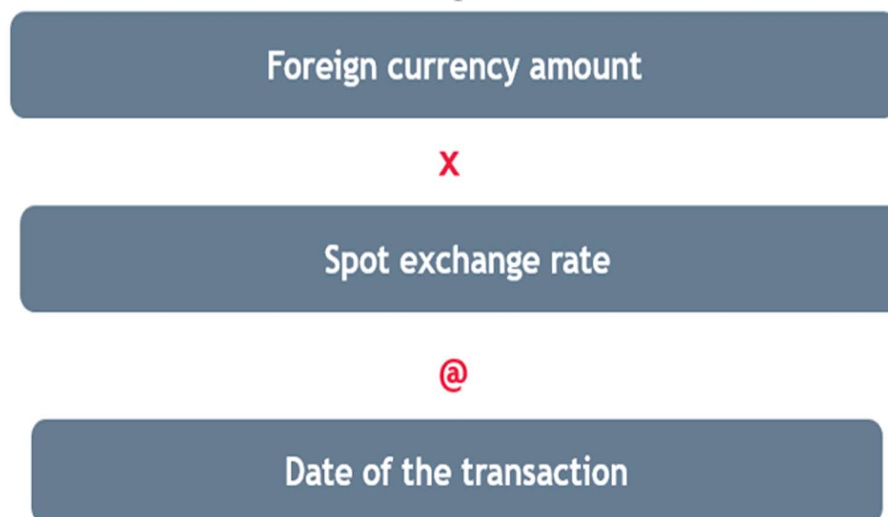
7.11.3.1 Analysis

The functional currency of Mining Co is US dollars because:

- This is the currency that mainly influences sales prices for goods and services, and the gold price is denominated and settled in US dollars.
- While labour costs are incurred in South African Rands, the currency that mainly influences the material and other costs of providing goods or services is arguably US dollars because capital equipment is purchased in US dollars.

7.12 Initial recognition of foreign currency transactions:

Foreign currency transactions are initially recorded in the entity's functional currency by applying the spot exchange rate to the foreign currency amount on the date of the transaction.



The date of the transaction is the date the transaction qualifies for recognition in accordance with other Accounting Standards. Practically, a rate that approximates the actual rate on the date of the transaction is often used, for example, an average rate for the month, but using average rates is not appropriate where there are significant fluctuations in the exchange rate during the period.

7.13 Subsequent recognition - monetary items:

At the end of each subsequent reporting period, any foreign currency monetary items are translated using the closing rate, or spot rate at the end of the reporting period.

7.13.1 What are monetary items?

'The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; lease liabilities; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: amounts prepaid for goods and services; goodwill; intangible assets; inventories; property, plant and equipment; right-of-use assets; and provisions that are to be settled by the delivery of a non-monetary asset.'

7.13.2 Subsequent recognition - non-monetary items:

Non-monetary items are recognised at the end of each subsequent reporting period as follows:

If measured at historical cost in a foreign currency translated is using the exchange rate at the date of the transaction. If measured at fair value in a foreign currency - translated using the exchange rate when the fair value was determined.

7.13.3 Where is the exchange difference recognised?

1. **Monetary items**

Exchange differences on monetary items may arise from:

- Translating unsettled monetary items at the end of a reporting period at closing rates different to the spot rates used at initial recognition (unrealised exchange differences).
- Settling monetary items at an exchange rate different to that used for initial recognition (if settled in the same accounting period the item is first recognised), or that is different to that used for subsequent recognition as noted above (realised exchange differences).

2. **Non-monetary items**

When the fair value of a non-monetary item is measured using a foreign currency (for example, a property held overseas where fair value is determined in the currency of the foreign jurisdiction), as noted above, the exchange rate used to determine fair value in the functional currency is the rate at the date when fair value was determined. This could differ from the original rates used to translate the item and results in an exchange difference.

IAS 21 requires the exchange difference component of the fair value movement on a non-monetary item to be recognised in the same way as the fair value movement. For example, the exchange component of a revaluation increment for PPE is recognised in other comprehensive income (OCI) but is recognised in profit or loss for investment property.

7.14 Net investment in a foreign operation:

As noted above, exchange differences arise when an entity borrows or lends money in a currency different to its functional currency and these are recognised in profit or loss because the exchange difference relates to a monetary item.If such transactions occur between group entities, and settlement is neither planned nor likely to occur in the foreseeable future, in substance, this forms part of the entity's 'net investmentin that foreign

operation'. In such cases, exchange differences on the foreign currency receivable or payable are recognised as follows:

- In separate or individual financial statements – in profit or loss.
- In financial statements that include the foreign operation (e.g., the consolidated financial statements if foreign operation is a subsidiary) – in OCI (foreign currency translation reserve).

That is, on consolidation, the exchange difference recognised is removed from profit or loss and recognised in OCI. Any amounts recognised in OCI on consolidation are only reclassified and recognised in profit or loss on disposal of the net investment.

7.15 What if an entity changes its functional currency?

An entity only changes its functional currency if there has been a change in facts and circumstances regarding the underlying transactions, events and conditions (refer to the discussion above regarding the hierarchy of factors to consider).The effect of changing functional currency is accounted for prospectively from the date of change.

7.16 Presentation currency is different to the functional currency:

Where an entity chooses a presentation that is different to the entity's functional currency, it must go through a process to translate the functional currency financial statements into the presentation currency. Where the functional currency is not considered hyperinflationary, the process is as follows:

- **Assets and liabilities**: Translate at the closing rate for each balance sheet presented.
- **Income and expenses** – Translate at exchange rates at the dates of the transactions (can use average rates unless there has been a significant fluctuation in exchange rates during the period).
- **Resulting exchange differences** – Recognised in OCI (foreign currency translation reserve).

7.17 Translating results and financial position of foreign operations:

If a foreign operation (e.g., subsidiary or a branch) has a different functional currency to the entity (parent entity), its results and financial position must be translated into the presentation currency of the reporting entity (parent entity in the case of a group). The process is the same as that described above for translating the functional currency into a different presentation currency. In addition:

- ➢ Any exchange differences recognised in profit or loss that are part of the entity's net investment in foreign operation are removed from profit or loss and recognised in OCI (refer discussion above for more information).
- ➢ Goodwill and any fair value adjustments to assets and liabilities arising on the acquisition of a foreign operation are treated as assets and liabilities of the foreign operation. This means they are expressed in the functional currency of the foreign operation and translated at the closing rate.

7.18 Disposals or partial disposals of foreign operations

On the disposal of a foreign operation, the cumulative exchange difference recognised in OCI is reclassified to profit or loss. Disposal may be through sale, liquidation, repayment

of share capital, or abandonment of all or part of that entity. A write-down to the carrying amount of a foreign operation does not constitute a partial disposal, so no part of the exchange difference recognised in OCI may be reclassified to profit or loss at the time of the write-down. The rules for reclassifying the exchange differences recognised in profit or loss to OCI are complicated where there is a partial disposal. Please contact BDO's IFRS Advisory Team us if you need assistance in this regard.

7.19 Foreign currency cash flows in the cash flow statement:

IAS 21 does not apply to presentation of foreign currency cash flows in the cash flow statement. Instead, IAS 7 Statement of Cash Flows requires:

- Cash flows arising from transactions in a foreign currency are to be recorded in an entity's functional currency by applying the exchange rate at the date of the cash flow (in practice this can be an average rate).

- Cash flows of a foreign subsidiary are to be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

In practice, entities are permitted to use a rate that approximates the actual rate, such as the weighted average exchange rate for the period. Unrealised gains and losses arising from changes in foreign currency exchange rates (e.g., translating a foreign currency borrowing to spot rate at reporting date) are not cash flows and are therefore not usually reported in the cash flow statement. However, if the entity holds a balance of cash and cash equivalents in a foreign currency (such as a New Zealand entity holding a USD bank account), movements in the exchange rate are reported at the bottom of the cash flow statement.

7.20 Over the Counter Traded Forwards:

Exchange traded futures contracts compare to forward trades which are available over the counter. With an over-the-counter forward trade, it is possible for the two parties involved to negotiate the terms and conditions of the agreement exactly as they would like. Theoretically, for a currency forward, two parties could agree to exchange any two currencies at any rate at any time in the future that they would like.

This is particularly important in FX hedging because it allows a business or individual who is exposed to risk from a potential change to the exchange rate to create the perfect hedge against this risk.

When it comes to companies that operate internationally, for example, it is usually possible to accurately quantify the amount of currency that a company needs to cover with a prearranged exchange rate. If a business were to hedge using a futures contract, they would be limited in terms of the amount that they could cover, the currencies they could cover, and the dates by which the contracted exchange would be completed. With an over-the-counter forward trade, however, they would be able to cover the exact amount of the exact currencies they would like to with an ideally matching contract completion date.

7.21 **The Forward Market vs. the Futures Market:**

A key aspect of the forward market is that it is a decentralised market, rather than a regulated market that exists on an exchange. Trading which doesn't take place on an exchange and happens informally, as with forward contract trading, is known as 'over the counter' or 'off exchange' trading. Where forward contracts are traded on exchanges, they

work differently and are known as futures contracts. Crucially, over-the-counter forward trades are far more useful in FX hedging than exchange traded futures contracts.

7.22 Futures Contract Definition:

7.22.1 Exchange Traded Futures

Futures trades are the exchange version of forward trades. They provide the same basic contractual agreement between two parties, but the exchanges on which they are traded regulate and standardise the agreements that are made.

Exchange traded currency futures contract will create an agreement between two parties whereby they will exchange a set amount of two specified currencies on or before a certain date in the future. Again, this will lock in the exchange rate for a future date. The difference is that the exchange standardises contracts that are agreed to on the exchange in terms of which currencies are traded, the amounts that can be traded, and the dates by which the exchange must take place.

There are a limited number of possibilities of what type of futures contract can be taken out on a futures exchange. While the exchange rates that are available will vary day to day, two parties who agree to a futures trade will have to choose from a limited number of currency pairings, amounts, and contract completion dates.

The Chicago Mercantile Exchange, for example, which is a major futures exchange, offers futures contracts for GBP/USD which have to be traded in amounts of 62,500 GBP with quarterly settlement dates in March, June, September, and December.

17.23 Difference between Forward Market and Futures Market:

People who are new to investing and trading frequently misunderstand the forward and futures markets. Here's a quick technique to tell the difference between the two.

Forward Market	Futures Market
This market deals with forward contracts only.	This market deals only with futures contracts.
It is a self-regulated market.	It is a market that is regulated by SEBI.
The contracts of this market are tailored based on needs, and they are not standardized.	The contracts of this market are standardized on predetermined sizes and lots.
The major risk of this market is that the participants are not needed to deposit a margin amount, and there is no exchange that can regulate transactions.	The risks of this market are moderate as they are minimized by margin amount and exchange regulation.
The settlement by delivery in this market is more than 90%.	The settlement by delivery here is less than 2% of the transactions.

17.24 Summary:

Forward contracts are financial instruments that allow parties to lock in a future exchange rate for a specified amount of a currency, at a predetermined date. These contracts mitigate the risk of fluctuating exchange rates, providing stability and predictability for businesses engaged in international trade. Currency forward contracts are a specific type of forward contract focusing on foreign exchange transactions. They enable companies to hedge against potential losses resulting from adverse currency movements. By agreeing on a rate in advance, businesses can effectively plan and budget for their international transactions, ensuring consistent pricing and minimizing financial uncertainty. Additionally, currency forward contracts facilitate strategic decision-making by offering a valuable tool to manage cash flows and protect profit margins, enhancing overall financial risk management.

17.25 Key words:

Speculation: Speculation involves trading a financial instrument involving high risk, in expectation of significant returns. The motive is to take maximum advantage from fluctuations in the market.

FX account: Forex accounts are financial accounts that allow individuals or businesses to participate in the foreign exchange market. They provide access to trade various currency pairs and offer features such as leverage, trading platforms, risk management tools, and market analysis resources.

IAS: International Accounting Standards (IAS) were the first international accounting standards that were issued by the International Accounting Standards Committee (IASC), formed in 1973.

Forward Market: In a forward contract, two parties agree to acquire or sell an asset at a certain price in the future. In contrast to options or futures contracts, both parties in this transaction are required to complete it. A buyer or seller can close their position by selling an option or futures contract before expiration. The parties to a forward contract must deliver the asset class, whether it is money, a commodity, or any other kind of security. You should be able to comprehend the forward market example if you know what a forward contract is.

Futures Market: A futures market is an auction market in which participants buy and sell commodity and futures contracts for delivery on a specified future date. Futures are exchange-traded derivatives contracts that lock in future delivery of a commodity or security at a price set today.

Over the Counter: Over-the-counter (OTC) is the process of trading securities via a broker – dealer network as opposed to on a centralized exchange like the New York stock exchange. Over-the-counter trading can involve stocks, bonds, and derivatives, which are financial contracts that derive their value from an underlying asset such as a commodity.

Cash flow statement: A cash flow statement is an important tool used to manage finances by tracking the cash flow for an organization. This statement is one of the three key reports (with the income statement and the balance sheet) that help in determining a company's performance. It is usually helpful for making cash forecast to enable short term planning.

17.26 Self – assessment questions:

1. What is the use of forward contracts?
2. How exchange rates are determined?
3. Write a note on accounting standards on currency translation.
4. Brief the concepts of 'functional currency' and 'presentation currency'.
5. How to show the cashflows of foreign currency transactions?
6. Forward market Vs. Futures market

17.27 Further readings:

1. Alan C. Shapiro, "Multinational Financial Management" (Wiley)
2. Ian H. Giddy and Gunter Dufey, "Managing Foreign Exchange Risk: Advanced Strategies for Global Corporations" (McGraw-Hill Education)
3. John J. Wild and Kenneth L. Wild, "International Business: The Challenges of Globalization" (Pearson)
4. John C. Hull, "Options, Futures, and Other Derivatives" (Pearson)
5. Shapiro, A. C., & Grinblatt, M., "Corporate Finance" (Prentice Hall)
6. Piet Sercu and Raman Uppal, "International Financial Markets and the Firm" (Academic Press)
7. Thomas J. O'Brien, "Foreign Exchange: A Practical Guide to the FX Markets" (John Wiley & Sons)
8. Donald J. Smith, "Global Banking" (Oxford University Press)
9. Richard J. Taffler and David A. Peel, "Management Control, Audit, and Regulation: A Comprehensive Overview" (John Wiley & Sons)
10. Shapiro, A. C., "Foundations of Multinational Financial Management" (Wiley)

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Lesson – 8

TECHNIQUES IN FOREIGN CURRENCY TRANSLATIONS

Learning objectives:

- ✓ To know the foreign currency translation methods
- ✓ To understand the differences of monetary and non – monetary methods
- ✓ To know the functional currency translation
- ✓ To understand the hedging concept
- ✓ To know about inflation accounting
- ✓ To understand the concepts of speculation and forwards of currency

Structure:

8.0 Introduction
8.1 Process of foreign currency translation adjustments
8.2 Techniques of foreign currency translation
8.3 Current Rate Method (CRM)
  8.3.1 Translation adjustments under the current rate method arise whenever
  8.3.2 The translation adjustment is calculated by
8.4 Temporal Method
  8.4.1 Determine the Functional Currency of the Subsidiary
  8.4.2 Classify Assets and Liabilities
  8.4.3 Monetary Items
  8.4.4 Non-Monetary Items
  8.4.5 Translate Monetary Items at Current Exchange Rates
  8.4.6 Translate Non-Monetary Items at Historical Exchange Rates
  8.4.7 Translate Income Statement Items
  8.4.8 Calculate Exchange Rate Differences
8.5 Monetary-Nonmonetary Method
8.6 Functional Currency Translation
8.7 Key concepts regarding functional currency translation
  8.7.1 Determining the Functional Currency
  8.7.2 Factors Influencing Functional Currency Determination
  8.7.3 Financial Statement Preparation
  8.7.4 Translation to Reporting Currency
8.8 Functional Currency Reassessment
8.9 Net Investment Hedge
  8.9.1 Objective of Net Investment Hedge
  8.9.2 Components of a Net Investment Hedge
  8.9.3 Hedging Process
  8.9.4 Accounting Treatment
  8.9.5 Effect on Financial Statements
  8.9.6 Risk Management and Decision-making
8.10Inflation Accounting
8.11Consolidation:
8.12Which one is the best?
8.13Accounting treatment of foreign currency transactions

8.14Summery
8.15Key words
8.16Self – assessment questions
8.17Further readings

8.0 Introduction:

Companies with international operations will have assets and liabilities, income and expenses in foreign currency. However, since the investors of the country of origin and the entire financial community are interested in the value of the state currency (HC), the foreign currency balance sheet account and the income statement must be assigned an HC value. In particular, the financial statements of MNC overseas subsidiaries must be spelled out from local currency to domestic currency before being consolidated with the parent's financial statements.

If the value of the currency changes in foreign exchange translation gains or losses may occur. Assets and liabilities spelled out at the current exchange rate (post-change) are considered exposed; translatable at the historical exchange rate (before the change) will retain its historical HC (state currency) value and, accordingly, be considered unexposed.

Translational exposure is simply the difference between an exposed asset and an exposed liability. Controversy among accountants'centres on where assets and liabilities are exposed and when the exchange rate difference gains and losses obtained by accounting should be recognized (reported in the income statement). An important point to be aware of in putting this controversy in perspective is that the gains or losses are accounting—that is, there is no cash flow involved.

8.1 Process of foreign currency translation adjustments.

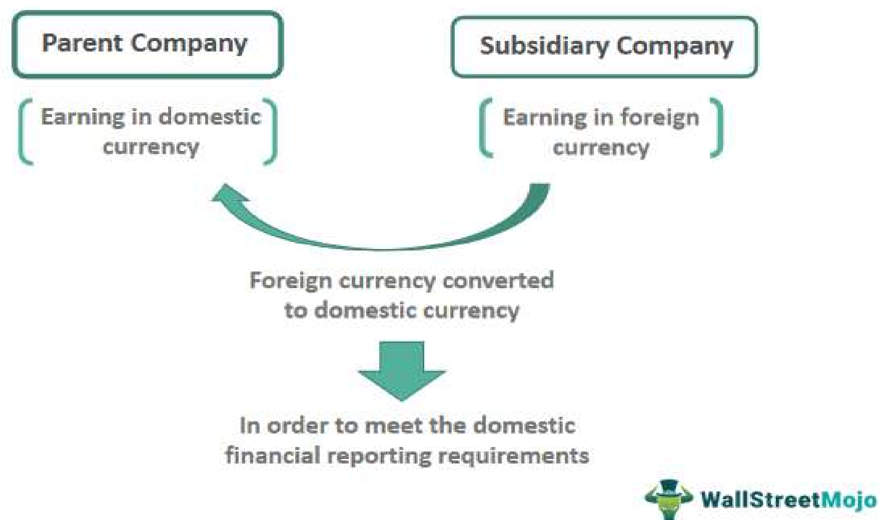
1. To translate the foreign subsidiary's financial statement into the parent company's reporting currency, it is to be ensured that the subsidiary's financial statement is prepared according to GAAP. So, the foreign currency translation process's first step involves matching the foreign entities' financial statements to US GAAP.

2. After that, the foreign entity's functional currency is to be determined, i.e., identifying the currency in which financial statements of the foreign currency are reported.

3. In the next step, foreign entities' financial statements will be reassessed in the functional currency which is generally its domestic currency.

4. Lastly, all the profits and losses from such currency translation will be recorded in the financial statements.

Note: This process will be followed at each of the balance sheet dates.



8.2 Techniques of foreign currency translation:

Foreign currency translation is the process of converting financial statements and other financial records denominated in one currency into another currency for reporting and consolidation purposes. This process is crucial for multinational companies that operate in multiple countries and need to present their financial information in a common reporting currency. Here are the key techniques used for foreign currency translation:

8.3 Current Rate Method (CRM):

Currency translation is a fundamental process for multinational corporations operating in multiple countries, aiming to consolidate their financial statements and provide a comprehensive view of their global financial position. The Current Rate Method (CRM) is one of the primary techniques employed for this purpose, facilitating the conversion of financial records denominated in foreign currencies into the reporting currency. This essay explores the intricacies and advantages of the Current Rate Method in foreign currency translation.

The Current Rate Method involves translating all balance sheet items, such as assets, liabilities, and equity, at the current exchange rate prevailing at the date of the financial statement. On the other hand, income statement items, including revenues, expenses, gains, and losses, are translated at the average exchange rate for the period under consideration. This method provides a straightforward and intuitive approach to foreign currency translation, simplifying the conversion process.

One of the significant advantages of the Current Rate Method is its simplicity and ease of use. By using current exchange rates, this method offers a direct and uncomplicated way to translate financial statements into the desired reporting currency. This simplification streamlines the translation process, making it accessible to a wide range of users within an organization, from financial analysts to executives, aiding in faster decision-making processes.

Moreover, the use of current exchange rates aligns with the concept of fair value accounting. The Current Rate Method allows for the reflection of the current market conditions and economic environment, providing a realistic representation of the subsidiary's financial position in the reporting currency. This helps in presenting a more accurate and up-to-date financial snapshot to stakeholders, enabling better insights into the multinational company's global operations.Furthermore, the Current Rate Method enables better comparability between subsidiaries located in different countries. By translating all foreign subsidiaries' financials using a consistent exchange rate, multinational corporations can analyze and compare their performance uniformly, disregarding any fluctuations in exchange rates. This promotes effective benchmarking and evaluation of the subsidiaries' financial performance and positions, enhancing the overall understanding of the organization's global operations.

However, it is important to note that the Current Rate Method is susceptible to currency fluctuations. Exchange rates are dynamic and can vary significantly over time, impacting the translated financial results. These fluctuations can affect the multinational corporation's reported financial position and performance in the reporting currency, introducing a level of uncertainty that necessitates careful monitoring and management.

The Current Rate Method (CRM) is a fundamental and widely utilized technique for foreign currency translation, offering simplicity, accuracy, and consistency in financial reporting. By employing current exchange rates for translation, this method ensures a straightforward and transparent approach, aligning with fair value accounting principles. While it has its challenges, the advantages of the Current Rate Method in promoting uniformity, comparability, and real-time representation of financials make it a valuable tool for multinational corporations aiming to navigate the complexities of global financial reporting.

8.3.1 Translation adjustments under the current rate method arise whenever:

1. Year-end foreign currency balances are translated at a current rate that differs from that used to translate ending balances of the previous period, and

2. Foreign currency financial statements are translated at a current rate that differs from exchange rates used during the period.

8.3.2 The translation adjustment is calculated by:

a. Multiplying the beginning foreign currency net asset balance by the change in the current rate during the period and

b. Multiplying the increase or decrease in net assets during the period by the difference between the average exchange rate and the end of-period exchange rate. The following depicts how the FAS No. 52 translation process applies to these figures.

Particulars	Foreign Currency	Exchange Rate	Dollar Equivalents
Balance Sheet Accounts			
Assets			
Cash	FC 500	$.18	$ 90
Accounts receivable	1,000	0.18	180
Inventories	1,500	0.18	270
Fixed assets	8,000	0.18	1,440
Total	**FC 11,000**		**$ 1,980**
Liabilities and Stockholders' Equity			
Accounts payable	FC 2,400	0.18	$ 432
Long-term debt	3,000	0.18	540
Capital stock	2,000	0.17	340
Retained earnings	3,600	a	404
Translation adjustment (cumulative)		b	264
Total	**FC 11,000**		**$1,980**
Income Statement Accounts			
Sales	FC 10,000	0.22	$2,200
Cost of sales	-5,950	0.22	-1,309
Depreciation	-1,000	0.22	-220
Other expenses	-1,493	0.22	-328
Income before income taxes	FC 1,557		$ 343
Income taxes	-467		-103
Net income	FC 1,090		$ 240
Retained earnings, (Date)	3,200		316
Less: dividends	-690		-152
Retained earnings, (Date)	FC 3,600		$ 404

a. See statement of income and retained earnings.
b. the cumulative translation adjustment of $264 is comprised of two parts:
- the cumulative translation adjustment at the beginning of the year and
- the translation adjustment for the current year and would be disclosed as a component of Other Comprehensive Income.

As can be seen, translation procedures under the current rate method are straightforward. However, the derivation of the beginning cumulative translation adjustment merits some explanation. Assume that calendar 2022 is the first year in which the current rate method is adopted (e.g., the previous translation method was the temporal method, as the U.S. dollar was considered functional before 2022). Under this scenario, a one-time translation adjustment would be calculated as of January 1, 2022. This figure approximates the amount by which beginning stockholders' equity would differ in light of the switch from the temporal to the current rate method. It is calculated by translating CM Corporation's January 1, 2022, foreign currency net asset position at the current rate prevailing on that date.

(This result simulates what CM's beginning net asset position would be had it used the current rate method all along.) The difference between this amount and the amount of net assets under the temporal method constitutes CM Corporation's beginning-of-period cumulative translation adjustment, as illustrated here.

Net assets, 12/31/10		FC 5,200
Multiplied by exchange rate as of 1/1/11 (FC1 = $.23)		X $0.23
Less: As reported stockholders' equity, 12/31/10 :		1,196
Capital stock	$340	
Retained earnings (per temporal method)	316	656
Cumulative translation adjustment, 1/1/10		$ 540

Given this information, the following steps yield a translation adjustment of $(276) for calendar 2011.

1. Net assets, 12/31/10			FC 5,200	
Multiplied by change in current rate: Rate,				
12/31/10	FC1 = $.23			
Rate, 12/31/11	FC1 = $.18		X$(.05)	$(260)
2. Change in net assets during year		FC 400		
(Net income less dividends)				
Multiplied by difference between average and year-end rate:				
Average rate	FC1 = $.22			
Year-end rate	FC1 = $.18		X$(.04)	$(16)
3. **Total**				$(276)

The final cumulative translation adjustment for 2011 of $264 is reached by adding the $(276) translation adjustment for 2011 to the beginning balance of $540.

8.4 Temporal Method:

The temporal method is used when the functional currency of a subsidiary is the currency of the country where it operates. In this method, monetary assets and liabilities are translated at the current exchange rate, while non-monetary assets and liabilities are translated at historical exchange rates (the rate at which the asset or liability was acquired).Income statement items are translated at the average exchange rate for the period.

The Temporal Method is an accounting technique used for translating financial statements of a foreign subsidiary from its functional currency (the primary currency of the country where it operates) to the reporting currency (the currency in which the parent company's financial statements are presented). This method is typically used when the functional currency of the subsidiary is different from the reporting currency.Here's how the Temporal Method works:

8.4.1 Determine the Functional Currency of the Subsidiary:

First, it's essential to identify the functional currency of the subsidiary, which is usually the currency of the country in which it primarily operates and generates its cash flows. The functional currency reflects the economic environment in which the subsidiary conducts its business.

8.4.2 Classify Assets and Liabilities:

Assets and liabilities are classified into two main categories:

8.4.3 Monetary Items:

These include cash, receivables, payables, and other financial instruments. They are translated at the current exchange rate.

8.4.4 Non-Monetary Items:

These include inventory, property, plant, equipment, and other non-financial assets and liabilities. They are translated at historical exchange rates.

8.4.5 Translate Monetary Items at Current Exchange Rates:

Monetary items are translated using the current exchange rate at the balance sheet date. This reflects the most recent exchange rate available for translating these items into the reporting currency.

8.4.6 Translate Non-Monetary Items at Historical Exchange Rates:

Non-monetary items, such as inventory and fixed assets, are translated using historical exchange rates. The historical rate is the exchange rate at the time the item was acquired or incurred.

8.4.7 Translate Income Statement Items:

Revenues and expenses are translated at the average exchange rate for the period.Depreciation and amortization expenses related to non-monetary assets are translated using historical exchange rates.

8.4.8 Calculate Exchange Rate Differences:

Any differences arising from the translation at different exchange rates (e.g., between historical and current rates) are recorded in a separate account called the "cumulative translation adjustment" (CTA). This account is part of shareholders' equity and captures the impact of exchange rate changes on the translation of the subsidiary's financial statements.

The Temporal Method aims to reflect the economic reality of the subsidiary's operations and assets by distinguishing between monetary and non-monetary items and using appropriate exchange rates for translation. It provides a more detailed and nuanced approach compared to the Current Rate Method, especially when the subsidiary's functional currency is different from the reporting currency. However, it can also introduce complexity and potential volatility due to fluctuations in historical exchange rates.

Example: In the **exampl**e:

Above, if there is an inventory of goods recorded in the balance sheet at its historical value of, say €1,000, its value in dollars after conversion will be $(1,000 x 1.2), or $1,200.

However, if the inventory of goods is recorded at the current market value of, say €1,050, then its value will be $(1,050 x 1.15), or $1,207.50.

8.5 Monetary-Nonmonetary Method:

This method involves distinguishing between monetary and non-monetary items. Monetary items (e.g., cash, receivables, payables) are translated at the current exchange rate,

while non-monetary items (e.g., inventory, fixed assets) are translated at historical exchange rates.

All monetary accounts are converted at the current rate of exchange, whereas non-monetary accounts are converted at a historical rate.Monetary accounts are those items that represent a fixed amount of money, either to be received or paid, such as cash, debtors, creditors, and loans. Machinery, buildings, and capital are examples of non-monetary items because their market values can be different from the values mentioned on the balance sheet.

The balance sheet prepared using the monetary/non-monetary method will be as follows:

Liabilities	Value (in €)	Value (in $)	Assets	Value (in €)	Value (in $)
Sundry Creditors (Current rate)	1,000	1,150	Cash in Hand (Current rate)	500	575
Long-term Debt (Current rate)	10,000	11,500	Sundry Debtors (Current rate)	1,500	1,725
Capital (Historical rate)	50,000	60,000	Buildings (Historical rate)	59,000	70,800

Source: CFI form net.

8.6 Functional Currency Translation:

This approach involves translating the financial statements of a foreign subsidiary into the functional currency of the reporting entity. The functional currency is the currency of the primary economic environment in which the subsidiary operates.

Functional currency translation is the process of converting financial statements and transactions from the functional currency of a foreign entity to the reporting currency of the parent company or consolidated group. The functional currency is the primary currency in which the foreign entity conducts its operations and generates its cash flows. Understanding and determining the functional currency is crucial for accurate financial reporting and analysis.

8.7 Key concepts regarding functional currency translation:

8.7.1 Determining the Functional Currency:

The functional currency is determined based on the economic environment in which the entity operates, the currency in which it primarily conducts its business transactions, and the currency that most influences its operating activities and cash flows.

8.7.2 Factors Influencing Functional Currency Determination:

Factors influencing the choice of functional currency include the location of the entity's headquarters, the currency in which it mainly generates revenue and incurs expenses, the currency of financing and debt obligations, and the currency of the country where it primarily operates.

8.7.3 Financial Statement Preparation:

Once the functional currency is identified, the entity prepares its financial statements in that currency for internal management reporting and compliance with local accounting standards.

8.7.4 Translation to Reporting Currency:

For consolidation purposes or when reporting to the parent company or a broader audience, the financial statements in the functional currency need to be translated into the reporting currency, typically the currency of the parent company.

8.8 Functional Currency Reassessment:

Changes in economic circumstances or the business environment may necessitate a reassessment of the functional currency. If the economic indicators shift significantly, the entity may need to change its functional currency and adjust its accounting accordingly.

Functional currency translation is essential for multinational corporations to present a consolidated and accurate view of their financial position and performance. It ensures consistency in financial reporting and allows for effective comparison and analysis of financial data across various entities operating in different countries with diverse currencies.

8.9 Net Investment Hedge:

This technique is used to translate the financial statements of a foreign subsidiary and protect against exchange rate fluctuations. It involves using forward contracts or other derivatives to offset the exchange rate impact on the net investment in the foreign subsidiary.

A net investment hedge is a financial risk management strategy used by multinational corporations to mitigate the exposure to foreign exchange rate fluctuations on their net investments in foreign subsidiaries. This hedge is particularly relevant when a parent company has subsidiaries in different countries and the value of these investments is subject to fluctuations due to changes in exchange rates.Here's a comprehensive note on net investment hedge with respect to currency translation:

8.9.1 Objective of Net Investment Hedge:

The primary objective of a net investment hedge is to protect the parent company's investment in a foreign subsidiary from the impact of adverse exchange rate movements. It helps in stabilizing the reporting currency value of the net investment in the subsidiary.

8.9.2 Components of a Net Investment Hedge:

- **Derivative Contracts:** Multinational corporations typically use financial derivatives, such as forward contracts, to hedge against the potential adverse effects of exchange rate fluctuations.

- **Hedged Item:** The net investment in the foreign subsidiary is the hedged item, and it's the value that the parent company seeks to protect.

8.9.3 Hedging Process:

- The parent company enters into a derivative contract (e.g., a forward contract) to buy or sell a specified amount of the foreign currency at a predetermined future date and exchange rate.

- The derivative contract's value is designed to offset the impact of exchange rate changes on the net investment in the foreign subsidiary.

8.9.4 Accounting Treatment:

- The changes in the fair value of the derivative contract are recorded in the income statement, helping to offset the changes in the fair value of the net investment due to exchange rate movements.

- This way, the gains or losses from the derivative contract help to offset the losses or gains on the net investment in the foreign subsidiary due to currency translation adjustments.

8.9.5 Effect on Financial Statements:

- Without the hedge, changes in the value of the net investment due to currency fluctuations would impact the parent company's consolidated financial statements, potentially causing volatility and affecting financial ratios.

- By using a net investment hedge, the parent company can stabilize the reported value of the net investment in the reporting currency, providing a more consistent financial picture to stakeholders.

8.9.6 Risk Management and Decision-making:

- The net investment hedge allows the parent company to manage its currency risk associated with its foreign investments more effectively, assisting in better decision-making and financial planning.

- It provides a level of certainty regarding the value of the net investment in the reporting currency, aiding in budgeting, forecasting, and investment strategies.

A net investment hedge serves as a risk management tool for multinational corporations, providing stability and predictability in reporting the value of net investments in foreign subsidiaries, ultimately supporting more accurate and consistent financial reporting.

8.10 Inflation Accounting:

An inverse relationship between a country’s rate of inflation and its currency’s external value has been empirically demonstrated.20 Consequently, use of the current rate to translate the cost of nonmonetary assets located in inflationary environments will eventually produce domestic currency equivalents far below their original measurement bases. At the same time, translated earnings would be greater because of correspondingly lower depreciation charges. Such translated results could easily mislead rather than inform. Lower dollar valuations would usually understate the actual earning power of foreign assets supported by local inflation, and inflated return on investment ratios of foreign operations could create false expectations of future profitability.

The FASB decided against inflation adjustments before translation, believing such adjustments to be inconsistent with the historical cost valuation framework used in basic U.S. statements. As a solution, FAS No. 52 requires use of the U.S. dollar as the functional currency for foreign operations domiciled in hyperinflationary environments (those countries where the cumulative rate of inflation exceeds 100 percent over a three-year period). This

procedure would hold constant the dollar equivalents of foreign currency assets, as they would be translated at the historical rate (by the temporal method). This method has its limitations. First, translation at the historical rate is meaningful only if differential rates of inflation between the subsidiary's host country and parent country are perfectly negatively correlated with exchange rates. If not, the dollar equivalents of foreign currency assets in inflationary environments will be misleading. Should inflation rates in the hyperinflationary economy fall below 100 percent in a future three-year period, switching to the current rate method (because local currency would become the functional currency) could produce a significant translation adjustment to consolidated equity, as exchange rates may change significantly during the interim. Under these circumstances, charging stockholders' equity with translation losses on foreign currency fixed assets could have a significant effect on financial ratios with stockholders' equity in the denominator. The issue of foreign currency translation cannot be separated from the issue of accounting for foreign inflation, which is treated at greater length in the next chapter.

8.11 Consolidation:

After the translation of the foreign subsidiary's financial statements into the reporting currency, the results are consolidated with the parent company's financial statements to present a consolidated financial picture of the multinational entity.

It's important for multinational companies to carefully choose and consistently apply a suitable translation method based on their specific circumstances and regulatory requirements to ensure accurate and meaningful financial reporting across different currencies.

8.12 Which one is the best?

We begin by asking whether a single translation method is appropriate for all circumstances in which translations occur and for all purposes that translation serves. Our answer would be, no. Circumstances underlying foreign exchange translation differ widely. Translating accounts from a stable to an unstable currency is not the same as translating accounts from an unstable currency to a stable one. Likewise, there is little similarity between translations involving import- or export-type transactions and those involving a permanently established affiliate or subsidiary company in another country that reinvests its local earnings and does not intend to repatriate any funds to the parent company in the near future. Second, translations are made for different purposes. Translating the accounts of a foreign subsidiary to consolidate those accounts with those of the parent company has very little in common with translating the accounts of an independent company mainly for the convenience of various foreign audiences-of-interest. We pose two additional questions:

1. What are acceptable foreign currency translation methods and under what conditions?
2. Are there situations in which currency translation may be inappropriate?

Regarding the first question, we think that there are three different translation approaches that make sense from a reader's viewpoint:

a. the historical method,
b. the current method, and
c. no translation at all. Financial accounts of foreign entities can be translated either from a parent company perspective or from a local perspective.

Under the parent company perspective, foreign operations are extensions of parent company operations and are, in large measure, sources of domestic currency cash flows. Accordingly, the object of translation is to change the unit of measure for financial statements of foreign subsidiaries to the domestic currency, and to make the foreign statements conform to accounting principles generally accepted in the country of the parent company. We think these objectives are best achieved by translation methods that use historical rates of exchange. We prefer the temporal principle, as it generally maintains the accounting principles used to measure assets and liabilities originally expressed in foreign currency units.9 Because foreign statements under a parent company perspective are first adjusted to reflect parent company accounting principles (before translation), the temporal principle is appropriate, as it changes a measurement in foreign currency into a measurement in domestic currency without changing the basis of measurement. The temporal translation method is easily adapted to processes that make accounting adjustments during the translation. When this is so, adjustments for differences between two or more sets of accounting concepts and practices are made along with the translation of currency amounts. For example, inventories or certain liabilities may be restated according to accounting practices different from those originally used. The temporal principle can accommodate any asset valuation framework, be it historical cost, current replacement price, or net realizable values.

The current rate method of translation is a straightforward translation (restatement) from one currency language to another. There is no change in the nature of the accounts; only their particular form of expression is changed. The current rate method is appropriate when the translated accounts of foreign subsidiaries keep the local currency as the unit of measure; that is, when foreign entities are viewed from a local (as opposed to a parent) company perspective. Translation at the current rate does not change any of the initial relationships (e.g., financial ratios) in the foreign currency statements, as all account balances are simply multiplied by a constant. This approach is also useful when the accounts of an independent company are translated for the convenience of foreign stockholders or other external user groups.

The current rate method is also appropriate when price-level-adjusted accounts are translated to another currency. If reliable price-level adjustments are made in a given set of accounts and if domestic price-level changes for the currency are reflected closely in related foreign exchange rate movements, the current rate translation of price-leveladjusted data yields results that are comparable to translating historical cost accounts under the historical rate translation method.

Are there situations in which currency translations can confuse rather than enlighten? We think so. No translation is appropriate between highly unstable and highly stable currencies. Translation of one into the other will not produce meaningful information using any translation method. No translation also means nonconsolidation of financial statements. We think this is reasonable. If a currency is unstable enough to put account translations out of the question, financial statement consolidation should also be out of the question. No translation is necessary when financial statements of independent companies are issued for purely informational purposes to residents in another country that is in a comparable stage of economic development and has a comparable national currency situation. Finally, certain special management reports should not be translated. Effective international managers should be able to evaluate situations and reach decisions in terms of more than one currency unit. Some internal company reports may have several different columns of monetary amounts, each in a different currency unit. Translation may be impossible for certain other reports

(such as those on a possible international acquisition) because historical foreign exchange rate information may not be available. Still other types of reports may translate current or monetary items only and leave other items untranslated.

Appropriate Current Rate Thus far we have referred to rates of exchange used in translation methods as either historical or current. Average rates are often used in income statements for expediency. The choice of an appropriate exchange rate is not clear-cut because several exchange rates are in effect for any currency at any time. There are buying and selling (bid and ask) rates, spot rates and forward rates, official rates and free-market rates, and so on. We believe that an appropriate translation rate should reflect economic and business reality as closely as possible. The free-market rate quoted for spot transactions in the country where the accounts to be translated originate is a rate that appropriately measures current transaction values.

Sometimes a country applies different exchange rates to different transactions. In these situations, one must choose among several existing rates. Several possibilities have been suggested:

- dividend remittance rates,
- free-market rates, and
- any applicable penalty or preference rates, such as those associated with imports or exports.

Where specific exchange controls are in effect (i.e., when certain funds are definitely earmarked for specific transactions to which specific foreign exchange rates apply), the applicable rates should be used

8.13 Accounting treatment of foreign currency transactions:

Accountants are faced with the problem of foreign currency transactions translation in the context of their recording in the books of accounts as well as in preparing a set of financial statements at the level of individual companies. In fact, it is those transactions that involve a settlement, i.e., debt collection or the payment of liabilities in a foreign currency. In addition to this, it is necessary that a strict distinction should be made between transactions in a foreign currency, on the one hand, and foreign trade, i.e., import-export transactions, on the other.

Actually, in any international transaction, there is only one party to be faced with the problem of accounting for them in a foreign currency because a payment is usually specified in a single currency. Consequently, only the party who is settling a liability or a receivable in a currency other than its national currency faces foreign currency transactions. Beside sales activities, transactions in foreign currencies mainly include borrowing or lending money as well as a dividend payment, similarly specified transactions in foreign currency:

- Purchases or sales of goods or services (imports or exports), the prices of which are stated in foreign currencies;
- Loans payable or receivable in a foreign currency;
- A purchase or sale of foreign currency forward exchange contracts;
- A purchase or sale of foreign currency units."

Accountants have assumed a unique attitude that the initial bookkeeping records of foreign currency transactions should be based on an effective exchange rate on the transaction date. Because of a potential utilization of a credit conditions during exchange-rate fluctuations, the unrealized part of the transaction, (the outstanding obligation and/or outstanding receivables in a foreign currency) should be adjusted in the balance sheet at a date before the payment date. However, if an amount of a settled transaction is different from a previously recorded one, accountants are faced with the problem of the treatment of the identified difference, i.e., gains and losses on foreign currency transactions. In this regard, the two aspects were differentiated, namely: a single-transaction perspective and a two-transaction perspective.

1. **Single-transaction perspective:** The real and the monetary part of a foreign currency transaction are treated as parts of single business event. The liability payment or accounts receivable collection in foreign currencies are considered to be an indispensable and inseparable part of a purchase or sale transaction, respectively. According to the single-transaction perspective, the effect of changes in foreign exchange rates at selling goods on credit to foreign customers are recorded on foreign currency accounts receivable and sales revenue. As the Sales account is closed at the end of the prior period, the negative effects of the changes in foreign exchange at the beginning of the period are included in the Retained earnings account. Therefore, this perspective could be remarked as to the effects of changes in exchange rates being masked by adjusting the Sales account, or the Retained earnings in respect of credit payment terms.

2. **Two –transaction perspective**: Foreign currency transactions are decomposed into a real and monetary segment, and a purchase or sale of goods, on the one hand, and the settlement of the obligation or the collection of a receivable, on the other, are separately treated. In other words, according to this perspective, exports and the correspondent collection are treated as two separate transactions. Since the management make two decisions on the sale of a product in an international market and also offer credit terms of payment to a foreign buyer, the effects of both of these decisions are stated separately in the income statement. The difference between the amount initially recorded on the transaction date and the amount by which the same is finally regulated (settled) is treated as a gain or a loss on a foreign currency transaction (transaction gains or losses). In other words, according to this view, initially recorded sales are not adjusted, but the effects of changes in exchange rates on foreign currency receivables are reported on as foreign exchange gains or losses.

Comparing these perspectives, it could be concluded that they both have an influence on a company's profitability in the same way. These perspectives differ in that, under the single transaction perspective, the amount of sales is adjusted for changes in exchange rates, and the effects of the more transparent of the two transaction perspectives are included in an exchange loss or gain.

While considering the effects of fluctuations in exchange rates in the context of the accounting treatment of foreign currency transactions, it is important to deal with the problem of the lack of a single, standardized method of the translation of the monetary part of a foreign currency transaction. In this regard, accountants have taken the view that the translation of the real part of a foreign currency transaction should be based on historical, i.e. transaction rates. On the contrary, there are three modalities of translation pointed out for the

translation of monetary assets (receivables) and liabilities denominated in foreign currencies by Flower:

1. at the historical rate. With this method, the home currency amount of these items is left unchanged and no translation gain or loss is reported.

2. At the closing rate. Translation at the balance sheet rate gives the current value of these items in terms of the home currency, i.e. the amount of money that would be received on the balance sheet date if the monetary asset were converted into the home currency (mutatis mutandis for liabilities). When the closing rate is different from the historical rate, a translation difference arises, which is generally taken as a gain or a loss in the income statement;

3. At the lower (higher) value of the historical rate and the closing rate for assets (liabilities). When this method is used, assets are stated at the lower of two possible values and liabilities at the higher one. The closing rate is only used if it gives rise to a loss on translation, which is charged to the income statement.

Since the first method can lead to an overestimation of monetary assets and an understatement of liabilities to their current values, it can be concluded that it is in direct contradiction to the principle of prudence. Therefore, the question of the argumentation and validity of such an approach is rightfully raised. Unlike this method, in the accounting literature, we can find well-founded arguments emphasizing the application of the second and third approaches.

According to the translation effects of the monetary part of foreign currency transactions (transaction gains and losses), the second method, which is based on the accrual principle, should be assigned to the accounting period in which a change in an exchange rate occurs rather than the period of cash and its equivalents collection or payment.

The third method is based on the principle of prudence. In the context of foreign currency transactions, this principle is affected by the restatement of monetary assets and liabilities at the historical or the current exchange rate resulting in a lower value of assets and a higher value of liabilities. Because of a possibility of exchange rates moving in the opposite direction in the future, which may neutralize the positive effects of the current period, "cautious (prudent)" accountants are not ready to show gains on the translation of the monetary part transaction in the current period, but rather have them disposed in the period in which foreign currency receivables or liabilities will undoubtedly be settled.

Summarizing the discussion on the pragmatic value of these methods, It is notes that the best solution is the one based on a compromising treatment of both methods and states that "monetary assets and liabilities should be valued at the closing rate, whereas the transfer of a gain to the income statement should be deferred until the foreign currency asset/liability has been realized.

Beside the problem of the accounting treatment of foreign currency transactions, comments on the current accounting regulations in the field of international business were investigated, with a special emphasis on the consistency of the application of IAS 21.

Accruals of the effects of exchange rate differences have for many years affected the financial position and profitability of a large number of companies. We should keep it in mind that the transfer of the effects of deferred foreign exchange differences to the income and expenses of the accounting period will affect the financial statements in the years to come.

8.14 Summery:

"Techniques in Foreign Currency Translations" is a pivotal lesson offering a strategic lens into navigating the intricate world of international finance. Through an exploration of forward contracts, transaction exposure risks, adherence to accounting standards, and the nuanced use of future contracts, this lesson equips individuals with the essential tools to effectively manage financial operations in the global arena. By mastering these techniques, one can confidently tackle the challenges of fluctuating exchange rates, optimize financial decision-making, and successfully navigate the dynamic landscape of cross-border transactions. Understanding and employing these techniques are fundamental in empowering businesses and financial professionals to thrive in an increasingly interconnected and competitive global marketplace.

8.15 Key words:

Net asset: Net assets are an important part of your business balance sheet. It is the sum total of everything your company owns (gross assets) minus the total cost of your debts (liabilities). The resulting figure is often referred to as your company's net asset value. The calculation is the same as for an individual's net worth.

Exchange Rate Differences: Exchange rate difference is the difference between estimates of the same number of units of foreign currency at different exchange rates (item 4 NAS 21). To calculate exchange rate differences, it is necessary to take only the official exchange rate of the National Bank. Ukraine’s interbank exchange rate or cross-rate is not used for this purpose. For example, the difference between the NBU exchange rate and the exchange rate on the interbank foreign exchange market of Ukraine, which arises during the purchase of foreign currency, is not an exchange rate difference in the sense of NAS 21. In accounting it is credited either to income (Cr 711 “Income from the purchase and sale of foreign currency”, or to expenses (Dt sub-account 942 “Expenses for the purchase and sale of foreign currency”).

Net Investment: What Is Net Investment? Net investment is the total amount of money that a company spends on capital assets, minus the cost of the depreciation of those assets. This figure provides a sense of the real expenditure on durable goods such as plants, equipment, and software that are being used in the company's operations.

Inflation accounting: Inflation accounting is the practice of adjusting financial statements according to price indexes. Numbers are restated to reflect current values in hyperinflationary business environments.

Consolidation: Consolidation in technical analysis refers to an asset oscillating between a well-defined pattern of trading levels. Consolidation is generally interpreted as market indecisiveness, which ends when the asset's price moves above or below the trading pattern. In financial accounting, consolidation is defined as a set of statements that presents (consolidates) a parent and subsidiary company as one company.

8.16 Self – assessment questions:

1. What is the process of foreign currency translation adjustments?
2. Write a note on various techniques of foreign currency translation.
3. Brief the current rate method.
4. What net investment hedge?
5. What is inflation accounting? How it operates?

8.17 Further readings:

1. "Multinational Financial Management" by Alan C. Shapiro (Wiley)
2. "Managing Global Financial and Foreign Exchange Rate Risk" by Ghassem H. Namvar (Wiley)
3. "International Financial Management" by Geert J. Bekaert and Robert J. Hodrick (Prentice Hall)
4. "Global Financial Management" by Alan C. Shapiro (Wiley)
5. "Foreign Exchange: A Practical Guide to the FX Markets" by Thomas J. O'Brien (John Wiley & Sons)
6. "International Finance: Theory and Policy" by Paul Krugman and Maurice Obstfeld (Pearson)
7. "Corporate Finance: A Focused Approach" by Michael C. Ehrhardt and Eugene F. Brigham (Cengage Learning)
8. "International Financial Management" by Cheol S. Eun and Bruce G. Resnick (McGraw-Hill Education)
9. "International Finance: An Analytical Approach" by Imad A. Moosa (Palgrave Macmillan)
10. "Foreign Exchange and Money Markets: Theory, Practice and Risk Management" by A. V. Rajwade and H. G. Desai (Vision Books)

Dr. K. Sivaji

Lesson – 9

ACCOUNTING FOR PRICE LEVEL CHANGES

Learning objectives:

After studying this unit, you should be able to:

- To understand the concept of Price Level Changes and its features and objectives.
- To know the different types or nature of price level changes.
- To assess the need for price level changes adjustment.
- To understand the advantages and disadvantages of price level changes.
- To know the recent trends in price level changes accounting in India.

Structure:

9.0. Introduction
9.1. Definitions and meaning of price level changes
9.2. Features of Price Level Changes Accounting
  9.2.1. Presents True Condition
  9.2.2. Facilitates Reasonable Comparison
  9.2.3. Remove Distortion
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9.3. Types/Nature of Price level Changes
  9.3.1. General Price level Changes
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  9.6. 1. Realistic View
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9.7. Disadvantages of Price Level Changes Accounting
  9.7.1. Alterations
  9.7.2. Complications
  9.7.3. Window Dressing
9.8. International Accounting Standards Board
9.9. Recent Trends in Price Level Changes Accounting in India
9.10. Factors Contributing to Price Level Changes
9.11. Summary
9.12. Key words
9.13. Self-Assessment Questions
9.14. Suggested Readings

9.0. Introduction

Inflation is an economic malaise which has plagued not only the less developed economies but has engulfed many nations of the industrialized world as well. The changing value of the monetary currency as a result of inflation has necessitated a re-examination of the stable measuring unit assumption in accounting. There is widespread agreement that historical cost accounts are unsatisfactory, particularly when price changes are significant. Since the late 1960's the accounting profession has been grappling with this problem, but no consensus has as yet been reached on a universally accepted formula regarding the adjustments necessary for price changes so that the financial statements reflect a true and fair picture.

9.1. Definitions and meaning of price level changes

Prior to an analysis of the need for accounting for price level changes, it would be appropriate to understand the nature of price changes.

Prices reflect the monetary expression of the exchange value of goods and services in an economy. Price changes, on the other hand, occur when the prices of goods or services are different from those which had been prevailing previously in the same market. The term purchasing power denotes the ability to buy goods and services with a given amount of money, say a rupee, compared with what the same amount could have purchased at an earlier date. These changes in the value of the monetary unit are known as inflation or deflation. Since price level changes the world over have tended to be inflationary, this discussion shall be restricted to inflation.

Webster's dictionary defines price level changes as, “an increase in the volume of money and credit relative to available goods recently in a substantial and continuing rise in the general price level”.

Price level changesrefers to Identify and incorporating the changes in prices of assets and liability of a company over a period of time.

The APB Statement 3 defines inflation as, a decline in the general purchasing power of money as the general level of prices of goods and services rises.Thus, inflation refers to a general increase in prices, the measure of which can be approximated by reference to a broadly based price index. Computing of an average or index of prices to express the general level of current prices compared with some base period is necessitated on account of the fact that prices usually move at different rates. In other words, it is not necessary that the prices of all goods and services will increase, or increase at the same rate.

According to Collins, (1997) Accounting for price level changes is a system of maintaining accounts in which all items in financial statements are recorded at current values. This system of accounting ascertains profit or loss and presents financial position of the business on the basis of current prices. Accounting for price level changes is also called inflation accounting.

In an economic sense, **Accounting** for price level changes refers to a quantitative measure of the rate at which the average price level of goods and services is increasing. Inflation accounting refers to a state in which the purchasing power

of money goes down for conversely. there is more money in circulation then is justified by goods and services the general weakness of traditional accounting system is that it falls to reflect the prices level change in the financial statement as it is based on historical cost.

9.2. Features of price level changes accounting:

9.2.1. Presents True Condition:

Inflation accounting presents true condition of company by adjusting all price level changes taking place in its financial statements. It depicts fair view of company's financial position by reflecting all changes as per the current price index.

9.2.2. Facilitates Reasonable Comparison:

It facilitates a fair inter-period comparison of business profits by bringing all expenses and income to current value. All financial statements such as Balance sheet and Profit and loss account shows present values in place of historical values which makes comparison a reasonable task.

9.2.3. Remove Distortions:

This branch of accounting helps in removing all distortions arising due to historical data. It makes accounting records reliable by updating all the data and matching current revenues with current expenses.

9.2.3. Check on Mis-leading Deeds:

Inflation accounting keep an eye over the misleading deeds of Historical cost concepts depicting higher profits and higher taxes, thereby resulting in more wages being demanded by workers seeing the high profits. When all adjustments as per the price level accounting is made, this kind of demand will not arise.

9.2.4. Improve Decision-Making:

It is an efficient tool with management which assist in efficient decision making. Inflation accounting provides reliable from of data that is adjusted to current price level. After adjustments, balance sheet exhibits fair position which helps managers in taking right decisions.

9.2.5. Inbuilt Automatic Mechanism:

Inflation accounting has an inbuilt and automatic mechanism for making adjustments as per the price level changes in company's book of accounts. It compares revenues and expenses at current cost for reflecting realistic position.

9.3. Types/nature of price level changes:

Price changes may be put into the following three categories, which are interdependent and not mutually exclusive:

9. 3.1. General Price Changes.

This has already been referred to and reflects an increase or decrease in the value of the monetary unit, measured by means of a price index.

For example, assume that the price index for consumer goods and services was 200 at the beginning of the year 1993 and at the end of the year it stood at 240. There is a 20 per

cent change in the prices-40/200 multiplied by 100. This is called the general price change, and the rate is 20 per cent.

9.3.2. Specific Price Changes.

Specific price changes on the other hand, reflect changes in the prices of a specific commodity or service.

For example, if the price of commodity X was Rs.150 at the beginning of the year and it is Rs.200 at the end of the same year, the specific price change is Rs.50. In percentage terms, it works out to 50/150 = 33.33 per cent. Specific price changes may occur on account of changes in the tastes of consumers, technological improvements, artificial or natural changes in the supply of the particular product or even as a consequence of changes in the value of money.

9.3.3. Relative Price Changes.

This type of price change reflects the change in the price of one commodity relative to the price of all goods and services. Changes in the price of specific goods reflect both general and relative price changes.

In the foregoing example, the relative price increase would be approximately 11.1 per cent. As all the prices increased by 20 per cent and the price of the specific commodity changes by 33.33 per cent, the relative price change would be equal to 133.33/120 x 100 - 1 = 11.01 per cent.

In conventional accounting with the use of historical costs, no price changes are isolated for separate reporting. The shortcomings of this are examined in the following section.

9.4. Objectives of accounting for price level changes:

Historical cost accounting financial statements are prepared on the assumption that monetary unit is stable. But in reality, monetary unit is never stable and most of the countries have been facing high rates of inflation. Therefore, financial statements prepared under historical cost accounting do not reflect current economic realities. They fail to give realistic and correct picture of the state if affairs of a concern. To overcome the limitation of historical cost accounting, there is a need to consider the effects of changes in value of money as a result of changes of price of goods and services. Following are the objectives of accounting for price level changes:

- To show the true result of the operations i.e. real profit or loss.
- To show the true financial position in current values.
- To show the realistic value of fixed assets in financial statement.
- To provide sufficient depreciation to generate funds for the replacement of fixed assets.
- To indicate the real capital employed.
- To make distinction between holding gain or loss and operating gain or loss.

- To make accounting records reliable for the various users

9.5. Need for price level changes adjustments

During a period of inflation, asset values recorded at their original acquisition costs seldom reflect the assets' current (higher) value. Understated asset values result in understated expenses and overstated income. From a managerial perspective, these measurement inaccuracies distort

(1) financial projections based on unadjusted historical time series data,
(2) budgets against which results are measured, and
(3) performance data that fail to isolate the uncontrollable effects of inflation.

Overstated earnings may, in turn, lead to:

- Increases in proportionate taxation
- Requests by shareholders for more dividends
- Demands for higher wages by workers
- Disadvantageous actions by host governments (e.g., imposition of excess profit taxes).

Should a firm distribute all of its overstated earnings (in the form of higher taxes, dividends, wages, and the like), it may not keep enough resources to replace specific assets whose prices have risen, such as inventories and plant and equipment.

Failure to adjust corporate financial data for changes in the purchasing power of the monetary unit also makes it hard for financial statement readers to interpret and compare reported operating performances of companies. In an inflationary period, revenues are typically expressed in currency with a lower general purchasing power (i.e., purchasing power of the current period) than applies to the related expenses. Expenses are expressed in currency with a higher general purchasing power because typically they reflect the consumption of resources that were acquired a while back (e.g., depreciating a factory purchased ten years ago) when the monetary unit had more purchasing power. Subtracting expenses based on historical purchasing power from revenues based on current purchasing power results in an inaccurate measure of income. Conventional accounting procedures also ignore purchasing power gains and losses that arise from holding cash (or equivalents) during an inflationary period. If you held cash during a year in which the inflation rate was 100 percent, it would take twice as much cash at the end of the year to have the same purchasing power as your original cash balance. This further distorts business-performance comparisons for financial statement readers. Therefore, it is useful to recognize inflation's effects explicitly for several reasons:

1. The effects of changing prices depend partially on the transactions and circumstances of the enterprise. Users do not have detailed information about these factors.

2. Managing the problems caused by changing prices depends on an accurate understanding of the problems. An accurate understanding requires that business performance be reported in terms that allow for the effects of changing prices.

3. Statements by managers about the problems caused by changing prices are easier to believe when businesses publish financial information that addresses the problems.

Even when inflation rates slow, accounting for changing prices is useful because the cumulative effect of low inflation over time can be significant. The distorting effects of prior inflation can persist for many years, given the long lives of many assets. And, as mentioned earlier, specific price changes may be significant even when the general price level does not change much.

9.6. Advantages of price level changes accounting:

The company reports very high profits during high inflation but on the other way faced financial difficulties. This happens because the taxes and dividends have been paid from the capital as a result of overstated profits arisen out of adopting the historical cost concept. Therefore, to alter this historical cost concept, price level accounting is recommended. The major advantages of price level changes aaccounting are as follows**:**

9.6. 1. Realistic View:

The price level accounting presents a more realistic view of the company's profitability. This happens because the current expenses/costs are matched with the current revenues only.

9.6. 2. Depreciation:

Depreciation is charged on the current value of assets in price level accounting. As a result, this enables the company to show their accounting profit closer to economic profits. Moreover, the replacement of assets can be done when required.

9.6. 3. Maintain Real Capital:

Helps the company to maintain real capital to avoid payment of taxes and dividends out of the capital due to inflated profits in accounting historically.

9.6. 4. Balance Sheet Reveals a Fair and True View:

The balance sheet also reveals a fair and true view of the financial position of the company since assets are valued at the current position and not in distorted historical values.

9.6. 5. Comparison:

Comparing becomes possible when price level accounting is adopted. This states that when financial statements are denoted according to the price changes, the profitability can be compared for two concerns developed at different times.

9.6. 6. Misled:

Employees, the public and the investors are not misled using inflation accounting which shows realistic profits. Without adjusting the price changes, higher profits create resentment and urge for higher wages among the workers. Moreover, new entrepreneurs get attracted by excessive profits to enter the business.

9.6. 7. Social Image:

The social image of the company that prepares the financial statements adjusted to the price level changes gets improved.

9.6.8 Investment Market:

The price level accounting establishes a realistic price for the shares which also affects the investment market of the company.

9.7. Disadvantages of price level changes accounting:

However, few people consider that the price level accounting may create problems instead of solving them. As result, they showcase the following disadvantages of price level accounting.

9.7.1. Alterations:

Altering accounts according to the price changes becomes a never-ending process. The process includes constant changes and adjustments in the financial statements.

9.7.2. Complications:

Inflation accounting does involve a bunch of calculations and makes the financial statements complicated. Therefore, it becomes difficult for the common man to understand, analyse and then interpret.

9.7.3. Window Dressing:

Price level accounting appears to have theoretical importance rather than practical due to which the adjustment in the accounts may lead to window dressing because of the element of subjectivity in it. People can alter the accounts according to the amounts most suited making the financial statements inaccurate.

9.7.4. Depreciation:

Depreciation charged on the assets on current values is not acceptable by the Income Tax Act, 1961. As a result, adjusting depreciation to price changes will not serve any practical purpose.

9.7.5. Deflation Period:

Lastly, in the deflation period, when the prices fall, adjustments mean overstatement of profits and charging lesser depreciation.

9.8. International accounting standards board:

The IASB has concluded that reports of financial position and operating performance in local currency are not meaningful in a hyperinflationary environment. IAS 29, 17 mentioned in conjunction with VESTEL's inflation-adjusted financial statements requires (rather than recommends) the restatement of primary financial statement information. Specifically, financial statements of an enterprise that reports in the currency of a hyperinflationary economy, whether based on a historical or currentcost valuation framework, should be re-expressed in terms of constant purchasing power as of the balance sheet date. This rule also applies to corresponding figures for the preceding period. Purchasing-power gains or losses related to a net monetary liability or asset position are to be included in current income. Reporting enterprises should also disclose:

1. The fact that restatement for changes in the general purchasing power of the measuring unit has been made.

2. The asset-valuation framework employed in the primary statements (i.e., historical or current-cost valuation)

3. The identity and level of the price index at the balance sheet date, together with its movement during the reporting period

4. The net monetary gain or loss during the period

9.9. Recent trends in price level changes accounting in India:

Price level changes, also known as inflation or deflation, play a pivotal role in the economic stability and growth of a nation. In the context of India, understanding recent trends in price level changes is essential for policymakers, businesses, and individuals to make informed decisions. This essay explores the recent trends in price level changes in India and discusses the factors contributing to these trends.

9.9.1 Recent Trends in Price Level Changes:

In recent years, India has witnessed fluctuations in its price level, largely driven by various economic, social, and global factors. Understanding these trends is crucial to evaluate the impact on consumers, businesses, and the overall economy.

9.9.1.1 Consumer Price Index (CPI) Inflation:

Consumer Price Index (CPI) measures the changes in the prices of a basket of goods and services consumed by an average urban or rural household. In recent years, India has experienced varying levels of CPI inflation. After a period of relatively high inflation, there has been a gradual decline in CPI inflation. This decline can be attributed to several factors, including the stabilization of food prices, lower fuel prices, and effective monetary policy measures.

9.9.1.2 Wholesale Price Index (WPI) Inflation:

The Wholesale Price Index (WPI) reflects price changes at the wholesale level and affects producers and manufacturers. In India, WPI inflation has also exhibited fluctuations. It has been influenced by factors such as international commodity prices, production costs, and government policies. To curb inflation, the Reserve Bank of India (RBI) and the government have adopted measures like interest rate adjustments and fiscal policies.

9.9.1.3 Core Inflation:

Core inflation, which excludes volatile food and fuel prices, has remained relatively stable compared to headline inflation. This stability can be attributed to prudent monetary policy by the RBI. However, rising non-food, non-fuel inflation, reflecting broader demand pressures, is a concern for policymakers.

9.10 Factors Contributing to Price Level Changes:

9.10.1 Global Factors:

Global factors play a significant role in influencing price level changes in any country:

1. Global factors, including international commodity prices and exchange rates, have a direct and immediate impact on a nation's price levels.

2. Fluctuations in global oil and commodity prices can affect the cost of imports, leading to inflation or deflation.

3. A depreciating national currency can increase the cost of imported goods, contributing to inflationary pressures.

4. Global economic conditions and financial market dynamics can influence the overall inflation rate in a country.

5. International trade agreements and tariffs can affect the prices of imported and exported goods, impacting domestic price levels.

6. Geopolitical tensions, conflicts, and trade disputes can disrupt the global supply chain and lead to price volatility.

7. International supply disruptions, such as natural disasters or pandemics, can cause shortages and price spikes.

8. Changes in global demand for a specific product or service can influence its price domestically.

9. Central banks often monitor global factors when setting monetary policy, aiming to maintain price stability.

10. Capital flows and foreign investment can affect a nation's money supply and, consequently, inflation.

11. Global economic events, such as financial crises, can have contagion effects on a nation's economy, causing price level changes.

12. Import-dependent industries can be particularly vulnerable to global price fluctuations, impacting their cost structure and profitability.

13. International energy prices can directly impact a country's fuel and transportation costs, affecting a wide range of industries.

14. Global factors also play a role in determining the cost of essential raw materials, affecting manufacturing and production costs.

15. Given the interconnected nature of today's global economy, monitoring and understanding global factors are crucial for policymakers and businesses to make informed decisions regarding price level changes.

9.10.2 Government Policies:

Government policies have a profound impact on price level changes within an economy:

1. Fiscal policies, such as taxation and government spending, directly influence aggregate demand and, consequently, inflation or deflation. Subsidies and price controls on essential goods can stabilize or distort price levels, especially in the case of food and fuel. A well-managed public distribution system can help control the prices of essential commodities and mitigate inflationary pressures.

2. Interest rate policies set by central banks, in coordination with the government, impact borrowing costs, affecting consumer spending and investment, which can influence price levels. The regulation of monopolies and competition policies can prevent price manipulation and promote fair pricing. Monetary policies, particularly the control of money supply, influence the rate of inflation by managing liquidity in the economy.

3. Government regulations and standards on quality and safety can affect production costs and, subsequently, prices. Monetary policies, particularly the control of money supply, influence the rate of inflation by managing liquidity in the economy.

4. Exchange rate policies can impact the cost of imports and exports, affecting domestic price levels. Trade policies, including tariffs and import/export restrictions, can impact the prices of foreign goods and the competitiveness of domestic products.

5. Public investment in infrastructure and development projects can stimulate economic activity, potentially leading to inflation if not balanced with adequate control measures. Government efforts to combat corruption and improve the business environment can indirectly influence price levels by promoting efficiency and competition.

6. Social welfare programs, if not properly targeted, can lead to higher government spending and potential inflationary pressures. Public debt management and the issuance of bonds can affect the government's fiscal position and interest rates, impacting price levels. Government policies aimed at promoting sustainable practices can influence production costs and potentially lead to changes in the prices of eco-friendly products.

7. Overall, government policies play a crucial role in maintaining price stability and ensuring that price levels are conducive to economic growth and the well-being of citizens. Careful policy design and implementation are essential to strike a balance between controlling inflation and fostering economic development.

9.10.3Food and Agricultural Factors:

Food and agricultural factors have a significant impact on price level changes within an economy:

1. Fluctuations in agricultural production and supply can directly affect the prices of food products, contributing to changes in the overall price level. Unpredictable weather events, such as droughts or floods, can lead to crop failures and reduced harvests, causing food shortages and price spikes.

2. Changes in global food prices and supply chain disruptions can influence the cost of imported and domestically produced food items.

3. Government policies related to agriculture, including subsidies and price supports, can stabilize or distort food prices. The availability and cost of essential inputs like fertilizers, pesticides, and water can influence agricultural production and price levels.

4. Seasonal variations in crop yields can impact the availability and pricing of agricultural products, leading to seasonal fluctuations in food prices. The efficiency and infrastructure of the agricultural supply chain, including storage and distribution, play a role in price stability.

5. The adoption of new agricultural technologies and practices can influence productivity and, consequently, food prices. Consumer preferences for certain food items and dietary changes can affect demand and, in turn, prices. Given that food is a fundamental component of the consumer price index, fluctuations in food and agricultural factors can have a direct and immediate impact on overall inflation and the cost of living for households.

9.10.4 Exchange Rates:

The exchange rate plays a crucial role in influencing price level changes in an economy:

1. **Import Costs:** Exchange rates directly impact the cost of imported goods and services. When a country's currency depreciates (weakens) against foreign currencies, the cost of imports increases. This can lead to higher prices for foreign goods, contributing to inflation.

2. **Export Competitiveness:** A depreciating currency can make a nation's exports more competitive in international markets. This can boost exports and, in turn, stimulate economic growth. However, it can also reduce the availability of domestically produced goods for the local market, potentially leading to higher domestic prices.

3. **Inflationary Pressure:** Exchange rate movements can transmit inflationary pressure into the economy. A weaker currency may lead to higher prices for imported raw materials, which can increase production costs for domestic industries and lead to higher consumer prices.

4. **Central Bank Intervention**: In many cases, central banks use exchange rate policies to manage inflation. They may choose to intervene in currency markets to stabilize or influence the exchange rate, depending on their inflation targets.

5. **External Shocks:** Exchange rates can be affected by external shocks such as financial crises or geopolitical events. These shocks can disrupt the stability of a currency and influence price levels by affecting the cost of imports.

6. **Investment Flows:** Exchange rate movements are influenced by capital flows, foreign investment, and investor sentiment. These factors can affect a country's money supply, impacting inflation rates.

7. **Import-Dependent Economies:** In countries heavily reliant on imports, exchange rate fluctuations can have a more pronounced impact on inflation, as changes in import costs are quickly reflected in consumer prices.

8. **Exchange Rate Regimes:** The type of exchange rate regime a country adopts, whether fixed, floating, or a managed float, can impact the extent to which exchange rates influence domestic prices.

9. **Expectations and Speculation:** Exchange rate movements are also influenced by market expectations and speculative trading. These can exacerbate or mitigate the impact of exchange rates on price levels.

10. **Exchange Rate Pass-Through:** The speed and extent to which exchange rate changes affect domestic prices can vary. Exchange rate pass-through refers to the degree to which exchange rate changes are translated into changes in domestic prices. Factors like market competition and pricing strategies of firms play a role in this pass-through effect.

Recent trends in price level changes in India indicate a complex interplay of various economic, social, and global factors. Policymakers and central authorities must remain vigilant in monitoring these trends and adopting appropriate measures to maintain price stability. Managing inflation is essential to ensure that consumers can maintain their purchasing power, businesses can plan for the future, and the overall economy can thrive. A balanced approach that considers both inflation control and economic growth is vital for India's economic development. In addition to that the following information has given:

a. India's growth in the first quarter of 2020-21 at -23.9% showed one of the highest contractions globally.

b. The 2020-21 real GDP growth for India is forecast in the range of -5.8% as per the RBI's Survey of Professional Forecasters to -14.8% as per Goldman Sachs

c. The Organisation for Economic Cooperation and Development (OECD) projected a contraction of 10.2% in the financial year 2021 for the Indian economy.

d. The annual projections also show a strong likelihood of even the nominal GDP growth showing a contraction for 2020-21.

9.11. Summary:

The changing value of the monetary unit as a result of change in price level has necessitated re-examination of the stable measuring unit assumption in accounting. There seems to be unanimity on the shortcomings of historical cost accounts, particularly where price changes are significant. This lesion was focused on the deficiencies in conventional accounting statements during a period of changing prices. Endeavour to describe the features, objectives and different types of price level changes and assess the need for price level changes adjustment. Further, discussed the advantages and disadvantages of price level changes.

9.12. Key words:

1. **General price level changes**: The general price level is a hypothetical measure of overall prices for some set of goods and services (the consumer basket), in an economy or monetary union during a given interval (generally one day), normalized relative to some base set.

2. **Wholesale Price Index (WPI) Inflation:** The Wholesale Price Index (WPI) reflects price changes at the wholesale level and affects producers and manufacturers.

3. **International accounting standards board:** The International Accounting Standards Board (IASB) is an independent, private-sector body that develops and approves International Financial Reporting Standards (IFRSs). The IASB was founded on April 1, 2001, as the successor to the International Accounting Standards Committee.

4. **Consumer Price Index (CPI) Inflation:** The Consumer Price Index (CPI) is a measure of the average change overtime in the prices paid by urban consumers for a market basket of consumer goods and services

9.13. Self-assessment questions:

1. What do you know about Accounting for Price Level Changes? State its main features.
2. How does Price Level Changes affect financial statements?
3. Explain different types or nature of price level changes
4. What are the objectives of accounting for price level changes?
5. Write a note on need for price level changes adjustment.
6. What are the advantages and disadvantages of price level changes?
7. Explain the recent trends in price level changes accounting in India.

9.14. Further Readings:

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Dr. G. Nagaraju

Lesson-10

TECHNIQUES OF PRICE LEVEL ADJUSTMENTS

Learning objectives:

- To acquire knowledge about need for study of price level changes adjustments
- To understand the factors causing distortion to accounting profit and financial statements.
- To assess different consequences of distorted profits measurement.
- To study the various methods of price level adjustments and its approaches.

Structure

10. 0. Introduction
10.1. Factors causing distortions to accounting profit and financial statements
    10.1.1. Cost of Goods Sold
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10.0. Introduction:

Many of the historical numbers appearing on financial statements are not economically relevant because prices have changed since they were incurred. Since the numbers on financial statements represent dollars expended at different points of time and, in turn, embody different amounts of purchasing power, they are simply not additive. Reported profits may exceed the earnings that could be distributed to shareholders without impairing

the company's ongoing operations. Future earnings are not easily projected from historical earnings. Future capital needs are difficult to forecast and may lead to increased leverage, which increases the risk to the business. The asset values for inventory, equipment and plant do not reflect their economic value to the business. Financial statements are an invaluable measure of your business's fiscal health. With that in mind, you'll need to acknowledge that they may not always give a true picture of the condition of your business and how you stack up against other businesses. Various factors can distort the reality on paper.

10.1. Factors causing distortions to accounting profit and financial statements:

During periods of inflation, numerous sources of error crop up in the traditional method of profit measurement as a result of which, reported profits are distorted. The accountant would generally define business profit as the excess of business revenue over related costs. This method of profit measurement, which is described as the profit statement approach, has been used by accountants for many years, and has generally been considered to be the best indicator of business profit. However, under inflationary conditions this matching is not satisfactory. Distortions arise on account of the following:

10.1.1. Cost of Goods Sold:

Most business enterprises experience a significant time-lag between the date on which the goods are purchased and the date when they are eventually sold. As a result, sales in a profit statement of the current year would usually be matched against a mix of purchases made partly in the current year and partly in the previous year. This matching of historic purchase costs against current sales results in considerable overstatement of profits.

10.1.2. Depreciation:

Depreciation on fixed assets exercises a decisive influence on distorting profits in periods of rising prices. The reason is not far to seek: Fixed assets owned by an enterprise are usually purchased on several different dates extending over many years in the past at costs representing a completely different purchasing power from what is in existence today. The depreciation charge, however, under historical cost accounting, is based on the assumption that the purchasing power is uniform, which creates significant errors in profit measurement. In a comparison of costs with revenue, it is essential that one matches like with like, which unfortunately does not happen in this case. Again, since the depreciation provision is based on the original monetary investment, replacement of the asset becomes difficult in case of rising prices. The depreciation provided on the basis of historical cost falls short of the cost of the asset consumed. The reported profits are overstated to the extent the depreciation is undercharged.

10.1.3. Miscellaneous Expenses:

Besides depreciation and cost of goods sold, there are certain other items of costs which relate to purchasing power of the previous year but are matched with current revenues. For instance, a market-overt company may incur heavy advertising and promotional expenditure and spread it over a number of years.

10.1.4. Purchasing power gains and losses:

Inflation is known to be beneficial to debtors and detrimental to creditors. Repayment to debtors is easier in terms of the economic sacrifice involved. The creditors sustain a purchasing power loss and the debtor makes a purchasing power gain during periods of inflation. Traditional accounting concepts, however, emphasize the allocations of costs to expenses and the recognition of gains through realization only at the time of external

transactions. Profits are distorted on account of this disregard for purchasing power gains and losses.

10.2. Consequences of distorted profits measurement:

Matching revenues realized during periods of rising prices with historical costs of resources acquired in the past when price levels were lower, generally leads to overstatement of profits. This reporting of inflated profits leads to numerous problems for the concern. Significant among them are:

10.2.1. Increase in Tax Liability:

Overstated profits lead to excessive taxation of the corporate sector in general and inequitable distribution of tax burden between companies. A UK report on small firms suggested that the average small company paid out 63 per cent of its real profits in taxation as opposed to the official rate of 45 per cent. Taxation of overstated profits in reality amounts to a tax on capital.

10.2.2. Erosion of Credibility of Financial Statements:

The interpretive value of accounts is highly reduced in periods of rising prices. In the conventional balance sheet, long-term assets are normally added together to produce an arithmetically correct but rather meaningless total. The items in the balance sheet are not comparable in the real sense as they are based on different levels of costs and prices.

10.2.3. Return on Capital:

A proper assessment of the earning capacity of an enterprise is also difficult. A key measure of performance is the return on capital employed, popularly known as the ROC or ROI. An inaccurate measurement of profit produces many situations where investors are led to believe that the enterprise is earning a more satisfactory return on capital than is actually the case. The rate of return is grossly misrepresented because it incorporates inflated reported profits on the one hand, and out-of-date asset values on the other. Both numerator and denominator used to obtain the quotient are defective.

10.2.4. Wage Claims:

With increase in organized labour, wage claims in recent years have been partly or wholly related to the prosperity of the enterprise. Overstated profits consequently result in a demand for a larger slice of the cake by the workers. Companies are forced into the settlement of wage claims on terms which they can ill afford, especially in industries where the labour unions are powerful.

10.2.5. Over-distribution of Dividends:

Inaccurate measurement of business profits may lead to a high rate of dividends being paid to the ordinary shareholders. This erosion of real capital may have serious consequences for the enterprise in time to come.

10.2.6. Liquidity:

Incompatible matching of cost of goods sold with sales, inadequate provision for depreciation, a fairly generous dividend policy and high wages all lead to a shortage of liquid resources. The cumulative effect is a financial strain on the management especially when substantial funds have to be found for large capital projects. This, in turn, leads to diminution of the operating capability of the enterprise.

It is thus evident that inflation has an undesirable effect on the usefulness to investors of information prepared under the traditional accounting model. Investors are concerned not with preserving and enhancing a particular number of rupees of invested capital but rather the purchasing power of that capital and its command over goods and services. There is, therefore, every need to account for price level changes in the financial statements. Many proposals, singly or in combination, have been put forward in recent years for dealing with the problem.

10.3. Price level adjustment methods:

Price Level Changes accounting has engaged the attention of accountants the world over. However, a clearly acceptable solution to the problem has yet to emerge. Numerous suggestions have been put forward and various solutions have been adopted in different countries at different times. It is virtually important to examine all the proposals. Important among them are:

1. Creation of Reserves.
2. Revaluation of Assets.
3. Last-in-first (LIFO) Method of Inventory Valuation.
4. Establishment of a complete system of Inflation Accounting.

10.3.1. Creation of Reserves:

One of the suggested solutions to the problem is to transfer to reserve, some of the profits available for distribution annually. The proponents of this approach contend that such transfers would ensure for distribution annually. The proponents of this approach contend that such transfers would ensure that there is no over-distribution of available profits, and would provide for the increased costs of assets replacement. The Institute of Charted Accountants of England and Wales had suggested that accountants should draw the attention of their clients to the desirability of setting aside amounts from profits and reserves in recognition of the effect of changes in the purchasing power of money upon the affairs of the business, particularly their effect on the amount of profits which, as matter of policy can prudently be regarded as available for distribution. Further, Institute suggested that first, profits be recalculated adjusting for general price level changes, and the difference between the conventional profits and recalculated profit be transferred to an inflation reserve. The Institute of Charted Accountants of India (ICAI) also makes a reference to creation of reserves, for a restricted purpose i.e., replacement of fixed assets, in its Statement on Auditing Practices.

The question which arises share is – how appropriate is the method as an inflation accounting technique. The proponents of the method generally argue that the profit which is transferred to reserves ensures that there is no over-distribution of profits in periods of inflation. The added advantage claimed is that whereas it does not go against conventional accounting methods, it achieves the same objective which the more complicated price level accounting methods are intended to.

This claim can be refuted because in the vast majority of cases in which such reserves have been created, no precise calculations have been made with regard to the effects of price level changes on the profits. Not only is the quantum of transfer to reserves arbitrary, but there is also an element of choice associated with it. Consequently, there is a danger that not only may such policies be abandoned for profit distribution. Again, since such transfers are

into most cases treated as appropriation of profits, they make little impact on the computation of current profits.

Hence, though the transfer to reserves is the simplest method of accounting for inflation, its effectiveness will depend on the size of the transfer and how it has been calculated. Besides, it does not take care of the problem of revealing a more realistic figure of profits nor does it indicate the effect of inflation on balance sheet items. Thus, despite its essential simplicity, accountants in many parts of the world have come to accept that the use of this method as a means of reporting the effects of inflation suffers from certain fundamental shortcomings necessitating the search for alternative methods.

10.3.2. Revaluation of Assets:

Revaluation of assets, fixed assets in particular, has also been made use of as a method of recording the effects of price variations in the annual financial statements. Revaluation refers to a revision in the book value of capital assets in accordance with a proper appraisal of such assets. In other words, it entails the establishment of proper values by a systematic procedure. Revaluation would thus disclose the cost of the fixed assets used by the firm in terms of current prices or current price levels, thereby providing a more realistic measure of capitalization, both for external financing purposes and for internal measurement of efficiency. It would also be a more uniform basis for intercompany comparisons.

A mere book entry for revaluation, however, does not by itself create funds for replacement of an asset. It is only by providing depreciation on the enhanced values of the assets that sufficient funds can be retained in the business to ensure that they will be made. Hence, if depreciation were continued to be charged on the basis of the original cost or original written down value, it would defeat the very purpose of revaluation. This adjustment in the depreciation charge also results in the profit and loss account reflecting some of the effects of price variation and if the adjustment is allowable for tax purpose, it eliminates one of the inflationary distortions from taxable profits. It is important that nay reserve created on revaluation should not be available for distribution as dividend.

It will thus be seen that revaluation of assets provides only a partial adjustment of the balance sheet-probably an important one-which has been made use of in many parts of the world. Companies in India have also occasionally revalued their fixed assets. As mentioned earlier, the issue of revaluation of fixed assets finds mention in the Statement of Auditing Practices issued by the ICAI. It recommends that "Members should advise clients about the need for setting aside appropriate amounts to provide for replacement of fixed assets either by periodic revaluation or by setting aside appropriate sums out of profits to reserves specially set aside for the purpose. If a company revalues its assets in order to bring into the balance sheet their replacement cost, depreciation on fixed assets must thereafter be provided for on the basis of the revalued figure. A number of companies in India have resorted to revaluation of fixed assets but the additional depreciation has generally been charged against the revaluation reserve. Besides, the policy is also not followed consistently. Thus, though revaluation does not provide a complete solution to the problem of financial reporting in an inflationary environment, it has been made use of quite extensively.

10.3.3. Last-in-first (LIFO) Method of Inventory Valuation:

Valuation of inventories according to the last-in-first-out (LIFO) method assumes that goods which are most recently added to stock are the first to be sold or consumed in

production. The two major consequences of the use of LIFO are that LIFO achieves a matching of current costs against current revenues as the cost of goods sold as shown in the income statement represents a collection of the most recent purchase costs. Secondly, it frequently results in depressing inventory values in the balance sheet, since the earliest purchase costs are taken. In periods of rising prices, these costs are bound to be low. Ordinarily, the amount of depressed inventory value in the balance sheet is directly proportional to the length of time the LIFO method has been in use.

The use of the LIFO method of inventory valuation as a mechanism for adjustment for rising prices has been criticized on several counts. These are:

(i) LIFO would not prove to be very effective in cases where purchases of inventory are made at infrequent intervals, since there could be a significant change in prices between the date of the last purchase and date when the latest sales took place.

(ii) In situations where the quantity of goods sold in the current year exceeds the quantity purchased, the costs figures would include the previous year's purchases or purchases made several years earlier resulting in an inflated figure of profits.

(iii) Another criticism leveled against LIFO is that it leads to depressed inventory valuation in the balance sheet; the figure generally represents the costs of many months or even years past. In other words, the more realistic figure of profit is obtained at the cost on the balance sheet which may be totally unrealistic as regards the stock or inventory value.

(iv) Besides, in some countries, LIFO is not acceptable for tax purposes since it has the effect of reducing the taxable profits. In such situations, companies may prefer to use the same stock valuation figure for both accounting and tax purposes.

10.3.4. Establishment of a Complete System of Inflation Accounting:

Under the previous three methods, only partial adjustments were made to remove the effects of price level changes. Under this method, adjustments are made to the yearend accounting statements for changes in the price level. Some important methods under this category are elaborately study in the next lesson.

10.4. Approaches of price level adjustments:

The phenomenon of global inflation adds a new dimension to the problem, because traditional methods of translation do not explicitly provide a cure for this malady. Hence, to provide meaningful information in the consolidated financial statements, the treatment of overseas inflation will entail stretching of the consolidation procedure to incorporate the adjustments for changing prices. A twofold procedure would therefore be necessary for consolidation purposes:

1. Adjustment or restatement of the financial statements of the subsidiaries for changing prices; and
2. Translation of the adjusted financial statements into the currency of the parent company.

Differences of opinion exist not only with regard to the order in which the procedure would be employed while consolidating the financial statements of subsidiaries, but also with regard to the manner in which the restatements would be made. Some writers such as Zenoff and Zwick, Parkinson, Shwayder and the Committee on International Accounting have recommended restatement of the subsidiary's financial statements to GPP using a foreign index, followed by translation at the closing rate of exchange. On the other hand Lorensen and Rosenfield who opine that a superior approach would be to first translate the financial

statements of the subsidiaries to the parent company currency and then restate of GPP for consolidation using the price index of the parent country.

A greater consensus, however, exists for current value accounting; Goudeket, Parker and the IASG all support the restate –translate approach. Nobes refers to an alternative approach for dealing simultaneously with translation and inflation, using purchasing power parities. The purchasing power parity (PPP) theory had been initially adopted by accountants as an alternative for exchange rates, particularly for measuring foreign exchange exposure. The proponents of the PPP theory concede that exchange rates are affected not only by inflation but other factors also, such as interest rate, balance of payments, political climate for the country, etc. Hence, they opine that the translate-restate (GPP) would be appropriate only for situations where exchange rate movements and relative price levels movements cancelled out. The recommendation to use the PPP theory has failed to gain general acceptance. Therefore, examine in greater detail the TWO popular approaches in use.

10.4.1. The Restate-Translate Approach:

As stated earlier, in the light of global inflation traditional translation methods which ignore the effects of rising price levels are inappropriate for managerial and investment decisions. To remedy this shortcoming Zen off and Zwick proposed that the financial statements of the subsidiaries, be first restated to reflect changes in the purchasing power of the foreign currency unit and then translated at the closing rate of exchange. The method affords certain advantages to the management of the MNCs and other users of financial statement. It is better suited to resource allocation as the management is able to evaluate the performance of the subsidiary in terms of the environment in which its assets are domiciled. Again, it provides a more appropriate measure of the performance of the subsidiary after providing for 'maintenance' of the affiliate's assets. In case of devaluation of the currency of a particular affiliate, the management is in a position to ascertain the effect of such currency devaluation.

This method is criticized for being inconsistent and less sound. Critics argue that it results in a unit of measure that reflects multiple standards in terms of general purchasing power.

10.4.2. The Translate-Restate Approach:

Critics of the restate-translate approach, therefore, recommend that foreign balances of the affiliates be first translated into the domestic currency of the parent and then restated for inflation using a parent country index. The method was originally proposed by APB Statement 3, which provided that foreign accounts are first translated into US dollars, then restated as their United States purchasing power equivalents, using the index of changes in the general price level in the United States.

This method has the advantage that it not only reveals in the financial statement the effects of changes in foreign currency exchange rates but also discloses the effect of parent country inflation on the prospective returns to the parent company investors. It is also deemed to be consistent and theoretically sounder, since the consolidated statements prepared according to this method would be expressed in terms of a single standard of measure, namely the purchasing power of the parent country.

The Lorensen and Rosenfield proposal is, however, not free from shortcomings. The restate-translate method provides a better measure of performance comparison of the

subsidiaries situated in countries with different levels of inflation, and is also more appropriate for resource allocation decisions. Besides, it would be wrong to assume that investors and managers of the parent country are unaffected by inflation in the affiliate country. It would also be inappropriate in countries suffering from hyperinflation. The International Accounting Standard IAS-29, Reporting in Hyperinflationary Economies, also provides for the use of the restate-translate method in such situation.

Since both the approaches suffer from certain shortcomings, the obvious question is – which construct is appropriate? The controversy can be resolved by addressing the issue from a decision-oriented framework. Maximization of the shareholders' wealth is generally the primary objective of corporate managers. Shareholders and potential shareholders are interested in the value of a firm's stock which, in turn, is a function of its discounted future divided streams and the perceived riskiness of that return stream. It is thus essential for managers to maintain the level of a firm's net operating cash flows over time, which are a function of both the firm's physical and technological capacity to produce goods and services, and the prevailing prices in the factor and product market. Hence, in deciding which approach is better, preservation of the firm's physical capacity to produce goods and services should be a significant factor. In the given scenario, specific price level adjustments would be more appropriate as against general price level adjustments. The restate-translate will be the preferred approach. Thus the financial statements of all the subsidiaries, domestic and foreign, are restated to reflect specific price changes. This is followed by translation using closing rates.

10.5. The Indian Experience:

India has too, been plagued with the problem of inflation for the last few decades. It is, therefore, appropriate to have an insight into the developments in this direction at different levels.

10.5.1 Government Level:

The Indian Companies Act, 1956 does not contain any specific provisions to take care of the impact of price level changes on the financial statements of companies. In 1977, the Economic Division of the Department of Economic Affairs of the Ministry of Finance, appointed a Committee under the Chairmanship of Mr. A. Bagchi, with the primary objective of examining the need and feasibility of inflation accounting in India. The Committee favoured the adoption of current cost accounting in India, for adjustment for the effect of inflation.

The tax laws in India do not permit depreciation provisions based on replacement cost. The Choksi Committee on Direct Tax Laws also did not favour the provision of depreciation on a replacement cost basis. However, in view of the prevailing inflationary trend in the country, the general rate of depreciation for tax purposes has been raised to 25% on the written down value basis.

Schedule-XIV to the Companies Act provides the minimum rates (both under the written down method and straight-line method) at which a company is required to change depreciation in its profit and loss account before declaring dividends. The rates of depreciation contained in the Schedule are lower than the rates of depreciation provided for under Income Tax Rules. The general rate according to the written down value method is 15%. A company is thus able to reflect a better financial position in its financial statements without paying higher tax.

10.5.2 Professional Level:

At the professional level, the attention of the Institute of Charted Accountants of India was drawn to the problem in the 1980s. This concern culminated in the issuance of a guidance note by the Research Committee in 982. The main objective of this guidance not is to encourage the adoption of accounting for changing prices, and to suggest a methodology relevant to the prevailing economic environment in India. The Committee considered the following proposals for accounting for changing prices:

1. Periodic Revaluation of Fixed Assets along with the adoption of the LIFO formula for inventory valuation.
2. The Current Purchasing Power Accounting Method (CPPA)
3. The Current Cost Accounting Method (CCA)

The Committee made certain recommendations after examining these three methods in detail. It considered the CCA method to be the most appropriate in the economic environment in India. It did not favour CPPA for, though simple, it did not provide for the maintenance of operating capability of the enterprise. The Committee acknowledged that the introduction of a full-fledged system of CCA on a wide scale in India would take time. Hence, in the transitional phase it recommended the periodic revaluation of fixed assets along with the adoption of the LIFO formula for inventory valuation. This, it felt, would reflect the impact of changing prices substantially in case of manufacturing and trading enterprises.

Considering the importance of the information regarding the impact of changing prices, it recommended that while primary financial statements should continue to be prepared and presented on the historical cost basis, supplementary information reflecting the effects of changing prices may also be provided for in the financial statements on a voluntary basis, at least by large enterprises. Further, since the presentation of statements adjusted for the impact of changing prices is voluntary, the enterprises may or may not get this information audited. The Committee felt, however, that the audit of such statements would enhance their credibility.

10.5.3 Corporate Level: A few business corporations in India, particularly in the public sector have attempted to incorporate the effects of inflation in their accounts. This information is included as unaudited supplementary statements in the annual reports of the companies. In most of the cases the current cost accounting method is followed. Quite a few companies are also resorting to revaluation of their fixed assets, though it is not done with regular periodicity. The resultant increase is generally transferred to a revaluation reserve. In some cases, however, it is taken to the capital reserve.

10.6. Summary:

Numerous suggestions have been put forward for adjustments in historical cost accounts to incorporate the effect of price level changes. These range from partial solutions such as such as creation of reserves, revaluation of assets and LIFO method of inventory valuation to more radical measures such as current value accounting. The two approaches in vogue are: 'restate-translate' and 'translate-restate'. Both these approaches suffer from a significant shortcoming in that they make use of general price level adjustments. Choi, therefore, suggests that specific price level adjustments would be more appropriate, following by translation using closing rate. Some writers question the validity of using current exchange rates for translation.

10.7. Key words:

Return on Capital: A key measure of performance is the return on capital employed, popularly known as the Return on Capital.

Last-in-first (LIFO) Method of Inventory Valuation: Valuation of inventories according to the last-in-first-out (LIFO) method assumes that goods which are most recently added to stock are the first to be sold or consumed in production.

Restate-Translate Method: This method used when a parent company consolidates the accounts of a foreign subsidiary located in an inflationary environment. With this method, first the subsidiary's accounts are restated for local inflation, and then are translated to parent currency.

Translate-Restate Method: A consolidation method that first translates a foreign subsidiary's accounts to parent currency and then restates the translated amounts for parent country inflation.

10.8. Self-assessment questions

1. What are the factors causing distortions to accounting profit via-a-vis financial statements?
2. Explain the various consequences of distorted profits measurements.
3. Examine the appropriateness of 'creation of reserves' as an inflation-accounting technique. How does it compare with revaluation of assets?
4. Critically evaluate the LIFO method of inventory valuation as a mechanism for adjusting rising prices.
5. Do you think the present state of inflation in India necessitates accounting adjustments? Which method would you consider appropriate and why?
6. "The restate-translate method of accounting for inflation is superior to the translate-restate method" - Comment.

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Lesson-11

METHODS OF PRICE LEVEL ACCOUNTING

Learning objectives

- To understand the different methods of price level accounting.
- To assess the appropriate method of price level accounting.
- To know the various methods of price level changes and its need.
- To understand the practical problems on various methods.

Structure

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11.1 Methods of price level changes accounting
11.2 Current Purchasing Power Method (CPP)
  11.2.1 Merits of CPP Method
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11.0. Introduction

During the last few decades, the accountants, Government Agencies and Professional Institutes have tried to evolve various methods to recognize the effect of changing prices on the financial statements. Henry Sweeney (1936) was the first to suggest a systematic approach to adjust financial statements for price level changes. He proposed valuation in terms of 'common dollars' for 'uniform purchasing power'. Bonbright (1937) proposed the concept of 'value to the owner' in an attempt to draw together various concepts like economic value, replacement value and realizable value. His main concern was with the questions of the legal damages which should be awarded for the loss of assets. He was not concerned with the impact of asset valuation on the determination of accounting profit. Kenneth MacNeal (1939) argued that financial statements purport to deal with present economic values and they are apt to be useful only to the extent that they do so. He suggested the market price of the asset as the proper value for accounting purposes. The proposals put forward are many and varied in their nature and implication. The literature available on price level accounting reveals that the following methods have been suggested by various researchers and professional accounting bodies in different countries to combat the impact of inflation on accounts.

11.1. Methods of price level changes accounting:

The following are the generally accepted methods of accounting for price level changes:

1. Current Purchasing Power Method (or) General Purchasing Power Method (CPP or GPP Method)
2. Replacement Cost Accounting Method (RCA)
3. Current Value Accounting Method (CVA)
4. Current Cost Accounting Method (CCA)

11.2 Current Purchasing Power Method (CPP):

Current Purchasing Power Technique of accounting requires the companies to keep their records and present the financial statements on conventional historical cost basis but it further requires presentation of supplementary statements in items of current purchasing power of currency at the end of the accounting period. In this method the various items of financial statements, i.e. balance sheet and profit and loss account are adjusted with the help of recognized general price index. The consumer price index or the wholesale price index prepared by the Reserve Bank of India can be taken for conversion of historical costs.

The main objective of this method is to take into consideration the changes in the value of money as a result of changes in the general price levels. It helps in presenting the financial statements in terms of a unit of measurement of constant value when both cost and revenue have been changing due to changes in the price levels. This technique of price level accounting has been followed by a number of companies in Germany, Australia and U.S.A. But although this method is simple, it may be considered as only a first step towards inflationary accounting.

11.2.1 Merits of CPP Method:

(i) This method is easy to understand and simple to apply.

(ii) Since general price index is applied for conversion of historical value to CPP, the conversion is objective and unbiased.

(iii) The CPP Method blends together the advantages of historical accounting with the objectivity of the general price index.

11.2.2 Weaknesses of CPP Method

(i) As it takes into account the general price index, it does not account for changes in the individual assets of the company. Sometimes it is possible that there may be an increase in the general price index, but there may not be any increase (rather there might be a decrease) in the value of a particular asset of a certain company.

(ii) The technique seems to be more of theoretical nature than of any practical utility.

(iii) In a country like India, even the price indices may not be correct and it may further cause inaccurate presentation of the financial statements.

11.2.3 Mechanism of Preparing Financial Statement under CPP Method:

A. Conversion Technique:

Current Purchasing Power Method (CPP) requires conversion of historical figures at current purchasing power. In this method, various items of balance sheet and profit loss account are adjusted with the help of recognized general price index. The consumer price index or the wholesale price index prepared by the Reserve Bank of India can be taken for conversion of historical costs. For this purpose, historical figures must be multiplied with the conversion factor. The conversion factor can be calculated with the help of the following formula:

$$\text{Conversion Factor} = \frac{\text{Price Index at the date of revaluation}}{\text{Price Index at the date of existing figures}}$$

B. Mid-Period Conversion:

There are several transactions which take place throughout the year such as purchases, sales, expenses, etc. For conversion of such items, average index of the year can be taken as the one index for all such items. If such an average is not available, the index of the mid-year is taken for this purpose. And, if the index of the mid-year is also not available, then the average of index at the beginning and at the end of the period may be taken.

C. Monetary and Non-Monetary Accounts (Gain or Loss on Monetary items):

For the conversion of historical costs in terms of current purchasing power of currency, it is useful to make a distinction between**:**

(a) Monetary accounts, i.e., money value items;
(b) Non-monetary accounts, i.e., real value items.

Monetary accounts are those assets and liabilities which are not subject to reassessment of their recorded values owing to change of purchasing power of money. The amounts of such items are fixed, by contract or otherwise in term of rupees, regardless of change in the general price level.

The examples of such items are cash, debtors, bills receivables, outstanding incomes, etc., as assets and creditors, bills payable, loans etc., as liabilities. Such items whose amounts are fixed and do not require reassessment are also known as money value items. Other assets and liabilities, the values of which do change or are subject to reassessment along-with the change in the purchasing power of money are called non-monetary items or real value assets and liabilities. Non-monetary items include items such as stocks, land, building, plant and machinery, etc.

It must be noted that, in the process of conversion, it is only the non-monetary items which are adjusted to the current purchasing power of money. Further, if assets and liabilities are converted as stated above, it may be found that a loss or gain arises from the difference of the converted total value of assets and that of liabilities. This loss or gain arises through monetary items or money value assets and liabilities i.e., cash, debtors, receivables, creditors, bills payable, etc., and not through real value assets and liabilities or non-monetary items.

D. Adjustment of Cost of Sales and Inventory:

As inventory is purchased in period n and sold in (n + x) period, there is a time gap between purchases and sales. During this time, there might be changes in the price levels. Because of inflation, the selling prices would indicate the value realized in terms of the increased price levels and costs which relate to the earlier periods would imply lower values. This results in over-statement of profits which are often misleading. The same is true is in deflation also, as current revenues are not matched with current costs. Hence, adjustment of inventory and cost of sales is very important. This adjustment depends upon the method adopted for the outflow of inventories, viz., first-in-first-out or last-in-first-out.

Under first-in-first out method (FIFO) cost of sales comprise the entire opening stock and current purchases less closing stock. The closing inventory is entirely from current purchases. But under the last-in-fist-out method (LIFO) cost of sales comprise mainly of the

current purchases and it is only when the cost of sales exceeds current purchases, opening stock enters into cost of sales. The closing stock enters current purchases opening stock enters into cost of sales. The closing inventory in LIFO is out of the purchases made in the previous year.

For adjusting the figures for price level changes, the following indices are applied:

(a) For current purchases—the average index of the year.
(b) For opening stock—the index at the beginning of the year.
(c) For purchases of previous year—the average index of the relevant year.

E. Ascertainment of Profit:

Profit under Current purchasing Power (CPP) accounting can be ascertained in two ways:

(i) Net Change Method: This method is based on the normal accounting concept that profit is the change in equity during an accounting period. Under this method, the openings as well as closing balance sheets are converted into CPP terms by using appropriate index numbers. The difference in the balance sheet is taken as reserves after converting the equity capital also. If equity capital is not converted, it may be taken as the balancing figure. It must be remembered that in the closing balance sheet, the monetary items will remain unchanged. Profit is calculated as the net change in reserves, where equity capital is also converted; and will be equal to net change in equity, where equity is not converted.

(ii) Conversion of Income Method: Under this method, the historical income statement is converted in CPP terms. Purchases, sales and other expenses which are incurred throughout the year are converted at average index. Cost of sales is adjusted as discussed in point (d) above. Depreciation can be calculated on converted values. Monetary gain or loss is also ascertained as explained in point, (c).

11.3 Replacement Cost Accounting Method:

Replacement Cost Accounting (RCA) Method is an improvement over Current Purchasing Power Technique (CPP). One of the major weaknesses of Current Purchasing Power technique is that it does not take into account the individual price index related to the particular assets of a company. In the Replacement Cost Accounting Method, the index used are those directly relevant to the company’s particular assets and not the general price index. In this sense the replacement cost accounting technique is considered to be an improvement over current purchasing power technique.

But adopting the replacement cost accounting technique will mean using a number of price indices for conversion of financial statements and it may be very difficult to find out the relevant price index to be used in a particular case. Further, the replacement cost accounting technique provides for an element of subjectivity and on this ground, it has been criticized by various thinkers.

11.3.1 Depreciation and Replacement of Fixed Assets:

Another problem posed by the price level changes (and more so by inflation) is that how much depreciation should be charged on fixed assets. The purpose of charging depreciation is twofold:

(i) To show the true and fair view of the financial statements and the profitability of the concern, and

(ii) To provide sufficient funds to replace the assets after the expiry of the life of the asset. Depreciation charged on historical or original cost does not serve any of the two purposes.

Suppose a machine was purchased in 2000 for Rs 1, 00,000 having a life of 10 years. In case depreciation is charged on original cost, after 10 years we shall have Rs 1, 00,000 from the total depreciation provided. But due to inflation the cost of the machine might well have gone up to Rs 2, 00,000 or even more in 2011 when the machine is to be replaced and we may find it difficult to replace the asset.

It proves that we have been charging less depreciation which resulted in overstatement of profits and higher payment of dividends and taxes in the past and insufficient funds now to enable the replacement of the asset. Hence, to rectify this, it is necessary that fixed assets are valued at replacement cost values and depreciated on such replacement cost values. But adopting replacement cost method is also not free from difficulties.

11.3.2 The main difficulties are as follows:

(1) It is not possible to find accurately the replacement cost till the replacement is actually made.

(2) The replaced new assets are not of the same type and quality as old assets because of new developments and improved qualities.

(3) Income Tax Act. 1961 does not provide for any other method than the actual cost method.

(4) The fixed assets should not be written-up in the balance sheet when the prices are not stable.

Hence, it may not be possible to charge depreciation on replacement cost basis. However, it is still advisable to retain profits ad restrict dividends so as to enable funds for replacement of fixed assets. For this purpose, ‘Specific Capital Reserves’ or ‘Replacement Reserves’ should be provided in addition to the normal depreciation provided on actual cost of the asset.

11.4 Current Value Accounting Method:

In the Current Value Accounting Method of price level accounting all assets and liabilities are shown in the balance sheet at their current values. The value of the net assets at the beginning and at the end of the accounting period is ascertained and the difference in the value in the beginning and the end is termed as profit or loss, as the case may be. In this method also, like replacement cost accounting technique, it is very difficult to determine relevant current values and there is an element of subjectivity in this technique.

The current value accounting method, often referred to as fair value accounting, is an approach that values assets and liabilities based on their current market prices or the present value of expected future cash flows. It contrasts with the historical cost accounting method, which records assets and liabilities at their original purchase cost, adjusted for depreciation or amortization over time. In essence, current value accounting reflects the current market conditions, providing more accurate and up-to-date financial information.

Relevance of Current Value Accounting in the Face of Price Level Changes:

1. **Reflecting Economic Reality:** Current value accounting captures the economic reality of assets and liabilities, especially in an environment of changing price levels. It accounts for fluctuations in the value of assets and liabilities, offering a more realistic representation of a company's financial position.

2. **Price Level Changes and Asset Valuation:** In times of inflation or deflation, the historical cost method may lead to distorted asset values. Current value accounting, on the other hand, adjusts for price level changes, ensuring that assets are valued at their current market prices.

3. **Enhanced Decision-Making:** Current value accounting provides decision-makers with real-time information about the financial health of a company. This is particularly important when considering investment decisions, mergers, acquisitions, or divestitures, as it helps assess the true economic value of assets.

4. **Risk Management:** In an environment with volatile price levels, current value accounting helps in assessing and mitigating risks associated with price fluctuations. Businesses can make more informed decisions about hedging strategies and risk exposure.

5. **Creditors and Investors:** Creditors and investors benefit from current value accounting as it offers greater transparency and enables them to make more accurate assessments of a company's financial stability, particularly in the context of changing economic conditions.

6. **Fair Valuation of Financial Instruments:** Current value accounting is particularly relevant for financial institutions, as it requires the periodic revaluation of financial instruments such as derivatives, which are highly sensitive to market price changes.

7. **Challenges and Subjectivity:** It's important to note that the fair value method can be subject to subjective judgments and estimations, making it susceptible to manipulation. However, when executed with integrity and in accordance with accounting standards, it can provide valuable insights.

The current value accounting method is a crucial tool in the accounting profession, especially in an environment characterized by changing price levels. It provides a more accurate and timely representation of assets and liabilities, aiding decision-makers, investors, and creditors in assessing the financial health and risk exposure of businesses. While it offers numerous benefits, it also poses challenges related to subjectivity and estimation. Nevertheless, when applied with transparency and adherence to accounting standards, current value accounting can be a valuable approach in the face of price level changes, providing a clearer picture of a company's financial position in dynamic economic environments.

11.5 Current Cost Accounting Method:

The British Government had appointed a committee known as Sandilands Committee under the chairmanship of Mr. Francis C.P. Sandilands to consider and recommend the accounting for price level changes. The committee presented its report in the year 1975 and recommended the adoption of Current Cost Accounting Technique in place of Current Purchasing Power of Replacement Cost Accounting Technique for price level changes.

The crux of the current cost accounting technique is the preparation of financial statements (Balance Sheet and Profit and Loss Account) on the current values of individual items and not on the historical or original cost.

11.5.1 Essential Characteristics of Current Cost Accounting Method:

1. The fixed assets are shown in the balance sheet at their current values and not on historical costs.
2. The depreciation is charged on the current values of the fixed assets and not on original costs.
3. Inventories or stocks are valued in the balance sheet at their current replacement costs on the date of the balance sheet and not cost or market price whichever is lower.
4. The cost of goods sold is calculated on the basis of their replacement cost to the business and not on their original cost.
5. The surpluses arising out of revaluation are transferred to Revaluation Reserve Account and are not available for distribution as dividend to the shareholders.
6. In addition to the balance sheet and profit and loss account, an appropriation account and a statement of changes is prepared.

The current cost accounting (CCA) technique has been preferred to the current purchasing power (CPP) technique of price level accounting as it is a complete system of inflation accounting. The financial statements prepared under this technique provide more realistic information and make a distinction between profits earned from business operations and the gains arising from changes in price levels.

As depreciation under CCA is provided on current cost, the method prevents overstatement of profits and keeps the capital intact. The effect of holding monetary items in terms of gains and losses having an impact on the finance of the business is also highlighted.

11.5.2 Important Adjustments Required under the CCA Method:

11.5.2.1 Current Cost of Sales Adjustment (COSA):

Under the CCA technique, cost of sales is to be calculated on the basis of cost of replacing the goods at the time they are sold. The important principle is that current costs must be matched with current revenues. As for sales are concerned, it is current revenue and out of the costs, all operating expenses are current costs. But in case of inventories, certain adjustments will have to be made, known as cost of sales adjustment.

Cost of sales adjustment can be calculated with the help of the following formula:

$$COSA = (C-O)-I_a\left(\frac{C}{I_c}-\frac{C}{I_c}\right)$$

Where
- C = Historical cost of closing stock
- O = Historical cost of opening stock
- I_a = Average Index number
- I_c = Index number appropriate to closing stock
- I_o = Index number appropriate to opening stock

11.5.2.2 Depreciation Adjustment:

Under the CCA method, assets are shown in the balance sheet on current replacement costs after allowing for depreciation. This will require an adjustment in depreciation also. Current year's depreciation under CCA can be calculated with the help of following formula:

$$\text{Current Year's depreciation} = \frac{\text{Opening Current Value of Assets + Closing Current Value of Assets}}{2 \text{ X Life of Asset}}$$

And, Depreciation Adjustment = Current Year's depreciation of CCA – Depreciation on historical cost

11.5.2.3 Backlog Depreciation:

Whenever an asset is revalued, the profit on revaluation is transferred to Revaluation Reserve Account. But the revaluation also gives rise to backlog depreciation. This backlog depreciation should be charged to Revaluation Reserve Account.

11.5.2.4. Monetary Working Capital Adjustment (MWCA):

Working capital is that part of capital which is required to meet the day-to-day expenses and for holding current assets for the normal operations of the business. It is referred to as the excess of current assets over current liabilities. The changes in the price levels disturb the working capital position of a concern.

CCA method requires a financing adjustment reflecting the effects of changing prices on net monetary items, leading to a loss from holding net monetary assets or to a gain from holding net monetary liabilities when prices are rising, and vice-versa, in order to maintain the monetary working capital of the enterprise. This adjustment reflects the amount of additional finance needed to maintain the same working capital due to the changes in price levels. The method of calculating MWCA is the same as that of COSA.

Symbolically:

$$MWCA = (C-O) - I_1\left(\frac{C}{I_c} - \frac{C}{I_0}\right)$$

Where
C = Closing Monetary Working Capital
O = Opening MWC
I_a = Average Index for the period
I_c = Appropriate Index for closing MWC
I_o = Appropriate index for opening MWC.

11.5.3 Current Cost Operating Profit:

Current cost operating profit is the profit as per historical cost accounting before charging interest and taxation but after charging adjustments of cost of sales, depreciation and monetary working capital.

11.5.4 Gearing Adjustment:

During the period of rising prices, shareholders are benefitted to the extent fixed assets and net working capital are financed while the amount of borrowings to be repaid remains fixed except interest charges. In the same manner, there is a loss to the shareholders in the period of falling prices. To adjust such profit or loss on account of borrowings, 'gearing adjustment' is required to be made. 'Gearing adjustment' is also a financing adjustment like COSA and MWCA. This adjustment reduces the total adjustment for cost of sales, depreciation and monetary working capital in the proportion of finance by borrowings to the total financing.

Gearing adjustment can be calculated with the help of the following formula:

$$\text{Gearing Adjustment} = \frac{B}{B+S} \times A$$

Where, B = Average net borrowings
S = Average Shareholders' interest
A = Total of the current cost adjustments.

11.5.5 Advantages of CCA Method:

(i) It is measuring the real profit or loss for the relevant year by taking due care of the inflationary reserve. This system also works well in case of deflationary situation.

(ii) It provides accumulating sufficient funds for replacing of assets by charging depreciation on current values.

(iii) The theory underlying the system that earnings and assets of an enterprise should be measured by reference to the value to the business of the assets is quite logical and useful.

(iv) The break-up of the assets and liabilities as given by the CCA represents a more accurate and real financial picture of an enterprise than that given by the historical cost accounting since CCA figures are with reference to the current prices.

11.5.6 Limitations of CCA Method:

(i) There is too much subjectivity element in CCA Method.
(ii) It does not provide adequately for back-long depreciation.

(iii) It fails to provide funds for replacement of new types of assets.

(iv) It ignores gains or loss on monetary items.

(v) The CCA operating gains do not reflect the real earnings (i.e. command over goods and services in general) of the firm.

(vi) Another criticism against the CCA is that the valuation method is ill-defined.

(vii) In view of the above shortcomings of the CCA, it does not seem to be generally acceptable to the enterprises and professional bodies.

Here's a comparison of the four accounting methods - Current Purchasing Power, Replacement Cost Accounting, Current Value Accounting, and Current Cost Accounting - in a table format, including their differences and limitations in the context of price level changes:

Accounting Method	Basis	Objective	Difference	Limitations
Current Purchasing Power	Adjusts for price index	Maintain constant purchasing power of capital	- Effectively counters inflation or deflation on statements.	- Single price index may not capture asset/liability effects. - Estimation of general price index can be subjective.
Replacement Cost	Replacement cost	Reflect changing market conditions	- Accurate representation of asset economic value.	- Complex, especially for unique or specialized assets. - Frequent revaluation can increase administrative burden.
Current Value	Current market prices	Reflect current market conditions	- Realistic financial position representation.	- Subjective and susceptible to manipulation. - May not be suitable for illiquid assets or assets with no active market.
Current Cost	Adjusts for replacement cost	Balance between historical cost and economic reality	- Less subjective than fair value accounting.	- Determining suitable replacement cost can be challenging. - May not fully capture rapidly changing market conditions.

11.6 Summary:

Under inflationary conditions, where prices are continually changing, traditional historical cost accounting becomes defective and misleading as a basis for decision-making. The major alternative techniques to accounting for price level changes are GPP accounting and current value accounting. GPP accounting includes all systems designed to maintain the current purchasing power of the corporation's equity. On the other hand, current value accounting includes all systems designed to account for changes in specific price such as current cost accounting and current exit or selling price accounting. Finally, assess the appropriate method of price level accounting.

11.7. Key words:

Current Purchasing Power Method: This method is also known as General Price Level Accounting. It adjusts historical cost based on changes in the general level prices, as measured by the general price level index. Changes in the general level of prices represent changes in the general purchasing power of the monetary unit.

Replacement Cost Accounting Method (RCA): Replacement Cost method involves arriving at an asset's value by reference to the present-day cost, in an arms-length transaction, of replacing that asset with a similar asset in a similar condition. The method can be used to value both an entire business and its individual assets.

Current Value Accounting Method (CVA): Current value accounting, also known as fair value accounting or mark-to-market accounting, is a method of accounting that measures and records the value of an asset or liability based on its current market price, rather than its original cost. The principle behind this approach is to provide a more accurate and up-to-date financial picture of a company.

Current Cost Accounting (CCA) Method: The current cost accounting (CCA) technique is adopted in place of the current purchasing power (CPP) of replacement cost accounting technique for price level changes. The crux of the CCA technique is the preparation of financial statements (balance sheet and profit and loss account) on the current values of individual items and not on the historical or original cost.

11.8 Self-assessment questions:

1. What do you mean by Current Purchasing Power Method? What are its merits and demerits?
2. ‘GPP converts an assembly of heterogeneous cost prices incapable of being compared with any degree of accuracy, into more comparable figures. Comment
3. Explain the mechanism to be used in preparation of financial statement under CPP Method.
4. How Replacement Cost Accounting Method differ from CPP Method? What is the purpose of charging depreciation on fixed assets under twofold?
5. Describe the essential characteristics of Current Cost Accounting Method.
6. What are the important adjustments required under the Current Cost Accounting Method.
7. What are its advantages and limitations of CCA Method?

11.9 Further readings

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Lesson-12

PRACTICAL APPLICATION IN PRICE LEVEL CHANGES ACCOUNTING

Learning objectives:

- To understand the different methods of price level changes properly.
- To able to use the price level changes accounting methods in different situations.
- To acquire the practical knowledge about price level change methods.

Structure:

12.0. Introduction
12.1.Illustration – 1& 2 on Conversion Technique
12.2 Illustration-3 on Monetary and Non-Monetary Accounts
12.3 Illustration-4, 5 & 6 on Adjustment of Cost of Sales and Inventory
12.4. Illustration –7 & 8 on Depreciation and Replacement of Fixed Assets
12.5. Illustration -9 on Current Cost of Sales Adjustment (COSA)
12.6. Illustration -10 onDepreciation Adjustment Method
12.7. Illustration -11 on Backlog Depreciation Method
12.8. Illustration -12 on Monetary Working Capital Adjustment (MWCA)
12.9. Illustration -13 on Gearing Adjustment
12.10. Summary
12.11. Key Words
12.12. Self-Assessment Illustrations
12.13. Suggested Readings

12.0. Introduction:

Theoretical frame work provide a wider range of understanding about the concept which you are studied. But it is very essential to get the practical or real experience is very essential to better understanding of the concept. The following are introduced with aim of providing such knowledge to the readers in the vide way. The examples are taken in the format to cover all the method of price level changes. Each illustration has been able to convey the better knowledge over the method.

12.1. On Conversion Technique: **Illustration – 1:**

A building was purchased in 2005 at a price of Rs.80,000. The general price index at that time was 150, convert the figure in current rupees on 21.12.2022 when the index stood at 300.

Solution:

$$\text{Conversion Factor} = \frac{\text{Current Price Index}}{\text{Previous Price Index at the date of existing figure}}$$

= 300/150=2

Converted Value = Historical Cost X Conversion Factor

= 80,000 X 2 = Rs.1,60,000.

Alternatively, Converted Value = 80,000 X 300/150 = Rs.1,60,000.

Illustration-2: Mr. X purchased a piece of land in 2015 for Rs.50,000 when the general price index was 125. He sold this piece of land in 2022 for Rs.1,05,000 when the general price index was 300. Calculate the profit or loss on the sale of land keeping aside the price level changes.

Solution:

Purchase price of land Rs.50,000

Sale Price Rs.1,05,000

It seems as if there is a profit of Rs.55,000 (1,05,000 – 50,000) but it is not so if the gain arising due to price level changes is ignored:

Converted value of land at 2022 index = 50,000 X 300/125 = Rs.1,20,000

So, there is rather a loss of Rs.15,000 (1,05,000 – 1,20,000)

12.2. On Monetary and Non-Monetary Accounts- Illustration-3:

A company has the following transactions at the given dates and price indices for the first quarter of 2008:

	Amount	Price Index
Opening Balance (Jan,1)	8,000	100
Cash Sales (Fe. 1)	15,000	104
Payment to Creditors (March, 1)	10,000	106
Cash Purchases (March, 1)	2,000	108
Payment of Expenses (March, 31)	4,000	110
Closing Balance	7,000	110

Calculate Monetary Gain or Loss.

Solution:

Particulars	Conventional Accounting (Rs.)	Conversion Factor (Rs.)	Converted Values (Rs.)
Opening Balance	8,000	110/100	8,500
Add: Cash Sales	15,000	110/104	15,865
(a)	23,000		24,665
Less: Cash Payments			
(i) Creditors	10,000	110/106	10,377
(ii) Purchases	2,000	110/108	2,037
(iii) Expenses	4,000	110/110	4,000
(b)	16,000		16,414
Closing Balance (a – b)	7,000		8,251
Expected Balance			8,251
Actual Balance			7,000
Monetary Loss			1,251

12.3 On Adjustment of Cost of Sales and Inventory: Illustration-4

From the information given below, ascertain the cost of sales and closing inventory under CPP method, if (i) LIFO and (ii) FIFO is followed:

Particulars	Amount (Rs.)
Inventory on 01-01-2021	20,000
Purchases during 2021	1,00,000
Inventory on 31-12-2021	30,000
General Price Index:	
On 01-01-2021	160
Average for the Year	180
On 31-12-2-21	200

Solution:

	Historical (Rs.)	Conversion Factor	Converted Values (Rs.)
(i) Under LIFO			
(a) Cost of Sales			
Opening Inventory	20,000		
Add: Purchases	1,00,000		
	1,20,000		
Less: Closing Inventory	30,000		
Cost of Sales	**90,000**	**200/180**	**-1,00,000**
(b) Closing Inventory			
Out of current purchases	10,000	200/180	11,111
Out of Opening Stock	20,000	160	25,000
	30,000		**36,111**
(ii) Under FIFO			
Cost of Sales and Closing inventory			
Opening Inventory	20,000	200/160	25,000
Add: Purchases	1,00,000	200/180	1,11,111
	1,20,000		**1,36,111**
Less: Closing Inventory	30,000	200/180	33,333
	90,000		**1,02,778**
(under FIFO, the closing inventory is entirely from current purchases and hence has been converted at average index)			
Closing Inventory	**30,000**	200/180	**33,333**

Illustration-5:

Arun Ltd. furnishes the following income statement for the year ending 31st December 2007, prepared on the basis of conventional accounting. You are required to adjust the same for price level changes under CPP Method.

	(Rs.)	(Rs.)
Sales		90,000
Less: Cost of Goods Sold:		
Opening Inventory	8,000	
+Purchases	60,000	
	68,000	
-Closing Inventory	6,000	
	62,000	
Add: Expenses:		
Wages and salaries	6,000	
Other Expenses	4,500	
Depreciation on Building	700	
Interest	300	**73,500**
Net Income		**16,500**
Less: Dividends		**4,000**
Retained Earnings		**12,500**

Additional Information:

1. Index of General Price Level
   January 1, 2007 100
   December 31, 2011 200
   Average Index 150
2. Interest and dividends are paid on December 31.
3. Building was purchased when index was 50.

Solution:

Particulars		Conventional Values (Rs.)		Conversion Factor	Adjusted Values (Rs.)	
Sales			90,000	200/150		1,20,000
Less:	Cost of Goods Sold:					
	Opening Inventory	8,000		200/100	16,000	
	+Purchases	60,000		200/150	80,000	
		68,000			**96,000**	
	-Closing Inventory	6,000		200/150	8,000	
		62,000			**88,000**	
Add:	Expenses:					
	Wages & Salaries	6,000		200/150	8,000	
	Other Expenses	4,500		200/150	6,000	
	Depreciation on Building	700		200/50	2,800	
	Interest	300		200/200	300	
			73,500			1,05,100
Net Income			**16,500**			**14,900**
Less:	Dividends		4,000	200/200		4,000
	Retained Earnings		**12,500**			**10,900**

Illustration - 6:
The Glamour Corporation has prepared the following comparative position statement (unadjusted):

	2011	
	January 1 (Rs.)	**December 31 (Rs.)**
Cash in Hand	Nil	15,000
Inventory	10,000	8,000
	10,000	**23,000**
Accounts Payable	6,000	9,000
Stockholder Equity:		
Paid-up Capital	3,000	3,000
Reserves	1,000	11,000
	10,000	**23,000**

Summary of the transactions for the year is as follows:

(i) Merchandise purchased evenly throughout the year cost Rs.3,000
(ii) Cash sales during the year were Rs.15,000
(iii) Cost of merchandise sold on FIFO basis was Rs.5,000

The conventional income statement prepared for the year was as follows:

Sales	Rs.15,000
Less: Cost of Goods Sold	Rs. 5,000
Income	**Rs.10,000**

General price index during the year indicated the following:
January 1, 2011-100, December 21, 2011- 200.

Assuming that all sales and purchases were made at an average of the period, beginning and ending price indices.

(a) Prepare comparative position statements for January 1, 2011 and December 31, 2011, where all items are expressed in terms of rupees of the value of December 31, 2011;
(b) Compute monetary gain or losses;
(c) Prepare an income statement that shows all items in rupees of year-end purchasing power. This statement should include the monetary gain or loss and a reconciliation of changes in the stock equity.

Solutions:

(a) Comparative Position Statement at Current Values

	Historical Values Jan 1, 2011 (Rs.)	**Historical Values Dec 31, 2011 (Rs.)**	**Conversion Factor**		**Converted Values Jan 1, 2011 (Rs.)**	**Converted Values Dec 31, 2011 (Rs.)**
			Jan 1	**Dec 31**		
Assets:						
Cash in Hand	15,000		200/200	--	15,000	
Inventory	10,000	8,000	200/100	--	20,000	14,000(I)
	10,000	**23,000**			**20,000**	**29,000**
Liabilities:						

Accounts Payable	6,000	9,000	200/100	200/200	12,000	9,000
Paid-up Capital	3,000	3,000	200/100	200/100	6,000	6,000
Reserves	1,000	1,000	200/100	200/100	2,000	2,000(b)
Income	--	10,000	--	--	--	10,000
Monetary Gain	--	--				2,000
	10,000	**23,000**			**20,000**	**29,000**

Working Notes:

(I) Valuation of Inventory

	Historical (Rs.)	**Conversion Factor**	**Converted Values (Rs.)**
Opening Balance	10,000	200/100	20,000
Add: Purchases	3,000	200/150	4,000
			24,000
Less: Cost of Goods Sold	5,000	200/100	-10,000
Closing Balance of Inventory			**-14,000**

(II) Calculation of Monetary Gain/Loss

(i) Cash

	Unadjusted Amount (Rs.)	**Conversion Factor**	**Adjusted Amount (Rs.)**
Opening Balance	--	--	--
Add: Receipts from Cash Sales	15,000	200/150	20,000
			20,000
Less: Payments	--		--
	15,000		**20,000**
Expected Balance of Cash	20,000		
Actual Balance of Cash	15,000		
Loss from holding cash	**5,000**		

(ii) Accounts Payable

	Unadjusted Amount (Rs.)	**Conversion Factor**	**Adjusted Amount (Rs.)**
Opening Balance	6,000	200/100	12,000
Add: Purchases	3,000	200/150	4,000
	9,000		16,000
Less: Payments	--		--
Closing Balance	**9,000**		**16,000**
Expected Balance of Accounts Payable	16,000		
Actual Balance of Accounts Payable	9,000		
Monetary Gain from Accounts Payable	7,000		
Net Monetary Gain (7,000-5,000)	**2,000**		

(c) Adjusted Income Statement (for the year ended Dec. 31, 2011)

	Historical Amount (Rs.)	Conversion Factor	Adjusted Amount (Rs.)
Sales	15,000	200/150	20,000
Less: Cost of Goods Sold (FIFO)	-5,000	200/150	10,000
Net Income	**10,000**		**10,000**

12.4. On Depreciation and Replacement of Fixed Assets: Illustration –7:

The following information has been extracted from the books of a company:

Year of Purchase	Cost of the Assets (Rs.)	Life in Years	Rate of depreciation on original cost
2000	50,000	20	5%
2006	80,000	10	10%
2011	1,40,000	7	15%

The general price index in 2000 (base year) was 100: in 2006,200 and in 2011 it was 300. The replacement cost of the assets on 31st December is Rs 80,000, Rs 1, 00,000 and Rs.1, 50,000 respectively.

You are required:

(i) To calculate the amount of depreciation up to 2000 on Historical Cost and Current Purchasing Power basis; and

(ii) To make necessary entries for recording the changes in the ledger using the index numbers and the replacement cost.

Solution:

Calculation of the value of Fixed Assets on Current Purchasing Power			
Year	**Historical (Rs.)**	**Index**	**Current Valuation (Rs.)**
2000	50,000	100	50,000 X 300/100 = 1,50,000
2006	80,000	200	80,000 X 300/200 = 1,20,000
2011	1,40,000	300	1,400,000 X 300/300 = 1,40,000

Calculation of Depreciation (As given rates)								
Year	**Rate of Depreciation**	**Total No. of Years**	**Cost (Rs.)**	**Historical Basis Dept. per years (Rs.)**	**Total Dept. (Rs.)**	**Current Value (Rs.)**	**Dept. per year (Rs.)**	**Total Dept. (Rs.)**
2000	5%	13	50,000	2,500	32,500	1,50,000	7,500	97,500
2006	10%	7	80,000	8,000	56,000	1,20,000	12,000	84,000
2011	15%	1	1,40,000	21,000	21,000	1,40,000	21,000	21,000
			2,70,000		**1,09,500**	**4,10,000**		**2,02,500**

Journal Entries			(Rs.)	(Rs.)
(a)	**Using the Index Numbers**			
	(1) Fixed Assets Account	Dr.	1,40,000	
	To Capital Reserve Account			1,40,000
	(Being the revaluation of fixed assets on the basis of index numbers recorded)			
	(2) Profit and Loss Account	Dr.	93,000	
	To Accumulated Depreciation Account			93,000
	(Being the amount of excess depreciation required on current purchasing power basis)			
(b)	**Using the Replacement Cost**			
	Fixed Assets Account	Dr.	60,000	
	To Capital Reserve Account			60,000
	(Being the increase in the value of fixed assets on replacement cost basis i.e. (80,000 + 1,00,000 + 1,50,000) – (50,000 + 80,000 + 1,40,000) transferred to Capital Reserve Account)			

Illustration - 8:

The following are the Balance Sheets of XYZ Company Limited:

Liabilities	2010 (Rs.)	2011 (Rs.)	Assets	2010 (Rs.)	2011 (Rs.)
Equity Share Capital	2,00,000	2,00,000	Land & Buildings at Cost (Purchased in 2003)	1,00,000	1,00,000
Profit & Loss Account	15,000	20,000	Plant & Machinery (Cost Rs.1,50,000 purchased in 2003)	75,000	67,500
Sundry Creditors	25,000	30,000	Inventories	30,000	37,500
			Sundry Debtors	20,000	25,000
			Cash	15,000	20,000
	2,40,000	**2,50,000**		**2,40,000**	**2,50,000**

The General price index was 100 in 2003 (base year), 200 in 2010 and 250 in 2011. No dividend was paid in 2011.

You are required to prepare:

(i) Supplementary Income Statement at current values.

(ii) Supplementary Comparative Balance Sheet at current values.

Solution:

Conversion of Assets at Current Values (2011 Index)					
Name of the Asset	**Conversion Factor**	**Historical Costs**		**Converted Values**	
		2010 (Rs.)	**2011 (Rs.)**	2010(Rs.)	2011 (Rs.)
Land & Buildings	250/100	1,00,000	1,00,000	2,50,000	2,50,000
Plant & Machinery	250/100	75,000	67,500	1,87,500	1,68,750
Inventories	250/200	30,000	37,500	37,500	37,500
Sundry Debtors	250/200	20,000	25,000	25,000	25,000
Cash	250/200	15,000	20,000	18,750	20,000
Conversion of Liabilities of Current Values (2011 Index)					
Sundry Creditors	250/200	25,000	30,000	31,250	30,000

Calculation of Loss from Holding Current Assets

	Historical Values (Rs.)	**Current Value (Rs.)**
Inventories	30,000	37,500
Sundry Debtors	20,000	25,000
Cash	15,000	18,750
	65,000	**81,250**

Loss = Current Values – Historical Values of Current Assets = Rs.81,250 – 65,000 = Rs.16,250

Calculation of Gain arising from current liabilities

From Sundry Creditors (Current Value – Historical Value) = Rs.31,250 – 25,000 = Rs. 6,250

Net Loss from Holding Current Assets and Current Liabilities = Rs.16,250 – 6,250 = Rs.10,000

Supplementary Income Statement at Current Values

	(Rs.)		(Rs.)
To Additional Depreciation, Current Values on Plant & Machinery	11,250(1)	By Balance of P & L A/c (20,000-15,000)	5,000
To Loss on Net Current Assets	10,000	By Loss for the Year	16,250
	21,250		**21,250**

(1) Depreciation Required = 1,87,500 – 1,68,750 = 18,750

Less: Depreciation already provided = 7,500

= **11,250**

Supplementary Comparative Balance Sheet at Current Values

Liabilities	**2010 (Rs.)**	**2011 (Rs.)**	**Assets**	**2010 (Rs.)**	**2011 (Rs.)**
Equity Share Capital	2,00,000	2,00,000	Land & Buildings	2,50,000	2,50,000
Revaluation Reserve	2,87,500	2,87,500	Plant & Machinery	1,87,500	1,68,750
Sundry Creditors	31,250	30,000	Inventories	37,500	37,500
			Sundry Debtors	25,000	25,000
			Cash	18,750	20,000
			Loss	--	16,250
	5,18,750	**5,17,500**		**5,18,750**	**5,17,500**

12.5. On Current Cost of Sales Adjustment (COSA) - Illustration -9

Calculate the 'Cost of sales adjustment' (COSA) from the following:

Historical Cost	Index Number	Rs.
Opening Stock	52,000	100
Purchases	2,20,000	110
Total Goods	2,72,000	(Average)
Less: Closing Stock	72,000	120
Cost of Sales	**2,00,000**	

Solution :

$$COSA = (C - O) - I_a\left(\frac{C}{I_c} - \frac{O}{I_o}\right)$$

$$\text{Or COSA} = (72{,}000 - 52{,}000) - 110\left(\frac{72{,}000}{120} - \frac{52{,}000}{100}\right)$$

$$= 20{,}000 - 110\,(600 - 520)$$

$$= 20{,}000 - 8{,}800 = ₹\ 11{,}200.$$

Cost of Sales Adjustment can also be calculated as under:	Rs.
Opening Stock at Average Index = 52,000 X110/120	57,200
Add: Purchases at Average Index	2,20,000
Total goods available at average index	2,77,200
Less: Closing stock at average index = 72,000 X 110/120	66,000
Current Cost of Sales	2,11,200
COSA = Current Cost of Sales – Historical Cost of Sales = 2,11,200 – 2,00,000 = 11,200	

12.6. Depreciation Adjustment Method: Illustration -10:

A machine was purchased on 1.1.2004 at a cost of Rs 10, 00,000 and its useful life was estimated to be 10 years. Its replacement cost was Rs 18, 00,000 on 1.1.2009 and Rs.20, 00,000 on 31.12.2009.

Calculate the amount of depreciation adjustment.

Solution:

$$\text{Current Year's Depreciation (CCA Method)} = \frac{18{,}00{,}000 + 20{,}00{,}000}{2 \times 10} = \text{Rs.}1{,}90{,}000$$

$$\text{Historical Depreciation} = \frac{10{,}000}{10} = \text{Rs.}1{,}00{,}000$$

Depreciation Adjustment = Current Year's Depreciation on CCA – Historical Depreciation

= Rs.1,90,000 – 1,00,000 = Rs.90,000

12.7. On Backlog Depreciation Method: Illustration -11

Compute the backlog depreciation from the information given in illustration -10

Solution:

Replacement cost of the machine on 1.1.2009 (Current Value) Rs.18,00,000

Expired Life on 1.1.1999 5 Years

Depreciation under CAA = 18,00,000 X 5/10 = Rs.9,00,000

Replacement/Current Value on 31.12.2009 Rs.20,00,000

Expired Life on 31.12.2009 6 Years

Depreciation under CCA = 20,00,000 X 6/10 = Rs.12,00,000

Difference in depreciation = 12,00,000 – 9,00,000 – Rs.3,00,000

Backlog Depreciation = Diff. in Depreciation – Depreciation Chargeable in Current Year

= 3,00,000 – 1,90,000 = Rs.2,10,000

Current Years' Depreciation has been calculated = 18,00,000 + 20,00,000 / 2 X 10

12.8 On Monetary Working Capital Adjustment (MWCA) - Illustration -12

Calculate the Monetary Working Capital Adjustment (MWCA) from the following data:

Particulars	01-01-2002 (Rs.)	31-12-2002 (Rs.)
Sundry Debtors	70,000	1,00,000
Sundry Creditors	30,000	40,000
Index Number	100	120
Average Index		110

Solution :

$$MWCA = (C - O) - I_a\left(\frac{C}{I_c} - \frac{O}{I_o}\right)$$

C = Closing Monetary Working Capital
= 1,00,000 – 40,000 = 60,000

O = Opening Monetary Working Capital
= 70,000 – 30,000 = 40,000

I_a = Average Index = 110

I_c = Closing Index = 120

I_o =Opening Index = 100.

Substituting the values :

$$MWCA = (60{,}000 - 40{,}000) - 110\left(\frac{60{,}000}{120} - \frac{40{,}000}{100}\right)$$

= 20,000 – 110 (500 – 400)

= 20,000 – 11,000 = ₹ 9,000.

12.9. On Gearing Adjustment Illustration -13

Particulars	Opening (Rs.)	Closing (Rs.)
Convertible Debentures	1,00,000	1,20,000
Bank Overdraft	60,000	80,000
Cash	10,000	30,000
Paid-up Share Capital	1,50,000	2,00,000
Reserves	50,000	80,000
COSA	20,000	
MWCA	15,000	
Depreciation	5,000	
Total of Adjustment	40,000	

Solution:

Calculation of Net Borrowings:

	Opening (Rs.)	Closing (Rs.)
Convertible Debentures	1,00,000	1,20,000
Bank Overdraft	60,000	80,000
Total Borrowings	**1,60,000**	**2,00,000**
Less: Cash (as this does not enter into MCWA	10,000	30,000
Net Borrowings	**1,50,000**	**1,70,000**
Calculation of Shareholders Funds:		
Paid-up Share Capital	1,50,000	2,00,000
Reserves	50,000	80,000
Shareholders' Funds	**2,00,000**	**2,80,000**

$$\text{Average Borrowings} = \frac{1,50,000 + 1,70,000}{2} = 1,60,000 \text{ (B)}$$

(or)

$$\text{Average Shareholders Interest} = \frac{2,00,000 + 2,80,000}{2} = 2,40,000 \text{ (S)}$$

$$\text{Gearing Adjustment} = \frac{B}{(B + S)} \text{ X A}$$

$$= \frac{1,60,000}{1,60,000 + 2,40,000} \text{ X } 40,000$$

As Total Adjustment A = 40,000 (given)

$$\text{Or, Gearing Adjustment} = \frac{1,60,000}{4,00,000} \text{ X } 40,000 = \text{Rs.}16,000$$

12.10. Summary

Inflation accounting is a strategy to factor the rising costs of goods around the world in the financial statements of companies during inflation. These costs are adjusted according to the figures reported by the international companies, which helps to present a clear picture of the firm's financial position. The reported figures rely on price indexes rather than simply depending on a cost accounting basis and are often used during times of inflation. Furthermore, referred to as price-level accounting due to its dependency on price indexes. This lesson explains how inflation accounting works, different methods of inflation accounting, its examples, benefits and limitations.

12.11Key Words

Monetary Working Capital Adjustment: Changes in price levels disturb the working capital position of a concern. The current cost accounting (CCA) method requires financial adjustments to be made to reflect the effects of changing prices on net monetary items.

Backlog Depreciation: A depreciation charge that occurs when an asset is revalued. The additional depreciation that arises as a consequence of the increase in the value of the asset also increases the accumulated depreciation; this increase is known as backlog depreciation.

Cost of Sales Adjustment (COSA): The COSA is an adjustment to the cost of sales to reflect the current costs of inventory at the time of sale. This adjustment is necessary because historical costs do not always match current costs.

12.12. Self-assessment illustrations

Problem- 1:

A company held shares in ABC Ltd. which it bought for Rs.21,000 in 2012 when an index of the general level of prices stood at Rs.105. at the end of 2021, the market price of the shares were Rs.18,000 and the index 125. At the end of 2022, the market price of the share was Rs.20,000 and the index 130.

(a) Calculate the CPP Value of the shares at the end of 2021 and 2022.

(b) Under CPP accounting, what gain or loss would be shown in respect of the shares?

(c) What, in fact, was the gain or loss in purchasing power in respect of the shares during 2022?

Problem- 2:

Compute the net monetary result of Apex Ltd. as on 31-12-2021 from the following information:

	01-01-2021	31-12-2021
Cash	20,000	25,000
Debtors	50,000	60,000
Creditors	70,000	80,000

Loan	70,000	30,000
Retail Price Index numbers:		
January 1, 2021		200
Average for the year		210
December 31, 2021		220

Problem- 3:

Given below is the balance sheet of Pragathi Limited as on March 31, 2022. You have to calculate the trading profits and holding gains, and the preparation of balance sheet under the Replacement cost accounting method.

Liabilities	Rs. ('000)	Assets	Rs. ('000)
Share Capital	2,800	Fixed Assets Inventory	2,000 800
	2,800		2,800

The fixed asset was acquired on March 31, 2022 and has an estimated life of five years with no scrap value. Additional information in respect of the year ending March 31, 2023 is as following:

	Rs. ('000)
Sales	4,000
Purchases at Historic Cost	1,400
Closing Inventory at Historic Cost	400
Closing Inventory at Replacement Cost	500
Cost of Goods Sold at Replacement Cost	2,000

It was also estimated that the replacement cost of the fixed asset had risen to Rs.2,40,000 by March 31, 2023. On the basis of the information given, compute:

(i) Current Operating Profit;

(ii) Holding Gains; and

(iii) Prepare a balance sheet in current value terms.

Problem- 4:

Historical Data	
Opening Stock	7,000
Purchases	46,000
	53,000

Less: Closing Stock	10,800
Cost of Goods Sold	42,200

Index for the cost of stock:
At the beginning of the year – 100;
End of the year – 120;
Average for the year – 110.
Calculate the cost of sales adjustment.

Problem - 5:

Ram started business on January 1, 2023 with an initial capital of equity shares worth Rs.24,00,000 and debentures worth Rs.4,00,000 carrying cumulative interest @12 per cent. On the same day, the company purchased a machine costing Rs.20,00,000 and stock/inventory of goods worth Rs.8,00,000. The management decided to provide depreciation at the rate of 10 per cent. On June 30, 2023, one-half of the goods were sold for Rs.12,00,000. The movements in the price index during the year were:

	January 1	**June 30**	**December 31**
General Price Index	100	120	132

With this information, prepare the income statement and the balance sheet of the company for the year ending December 31, 2023, according to the General Purchasing Power Accounting. (Ignore the Income Tax).

12.13. Further readings:

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Lesson – 13

TRANSFER PRICING

Learning objectives:

- ✓ To know the concept of transfer pricing
- ✓ To understand the features of transfer pricing
- ✓ To know the historical prospect of transfer pricing
- ✓ To understand the various aspects of transfer pricing
- ✓ To understand the importance of transfer pricing
- ✓ To know the drawbacks and risks with transfer pricing

Structure:

13.0 Introduction
13.1 Definition of transfer price
    13.1.1 Graphical presentation
13.2 Features of the transfer pricing
13.3 Historical prospects of transfer pricing
13.4 Relevance of tax treaties
13.5 Understanding Transfer Pricing
13.6 Various aspects of transfer pricing
13.7 Importance of Transfer Pricing
    13.7.1 Globalization
    13.7.2 Specialization
    13.7.3 Mergers and Acquisition
    13.7.4 Fair distribution
    13.7.5 Benefit to tax authorities
13.8 Objectives of transfer pricing
13.9 Purpose of transfer pricing
13.10 Drawbacks and risks with transfer pricing
13.11 Transfer Pricing and Taxes
13.12 Challenges of transfer pricing - India
13.13 Transfer Pricing defined by IRS
13.14 Internal Revenue Service and Transfer Pricing
13.15 Summery
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13.17 Self – assessment questions
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13.0 Introduction:

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfer to another goods or services, for a price. That price is known as "transfer price". This may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces. 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.

13.1 Definition of transfer price:

"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. Knowledge of transfer pricing and its various models can help you understand how companies use this technique to improve their accounting process and save taxes".

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

"Transfer pricing is the method used to sell a product from one subsidiary to another within a company. This approach is used when the subsidiaries of a parent company are measured as separate profit cents. Transfer pricing impacts the purchasing behaviour of the subsidiaries, and may have income tax implications for the company as a whole. Here are the key issues":

- **Revenue basis**. The manager of a subsidiary treats it in the same manner that he would the price of a product sold outside of the company. It forms part of the revenue of his subsidiary, and is therefore crucial to the financial performance on which he is judged.

- **Preferred customers**. If the manager of a subsidiary is given the choice of selling either to a downstream subsidiary or to outside customers, then an excessively low transfer price will lead the manager to sell exclusively to outside customers, and to refuse orders originating from the downstream subsidiary.

- **Preferred suppliers**. If the manager of a downstream subsidiary is given the choice of buying either from an upstream subsidiary or an outside supplier, then an excessively high transfer price will cause the manager to buy exclusively from outside suppliers. As a result, the upstream subsidiary may have too much unused capacity, and will have to cut back on its expenses in order to remain profitable.

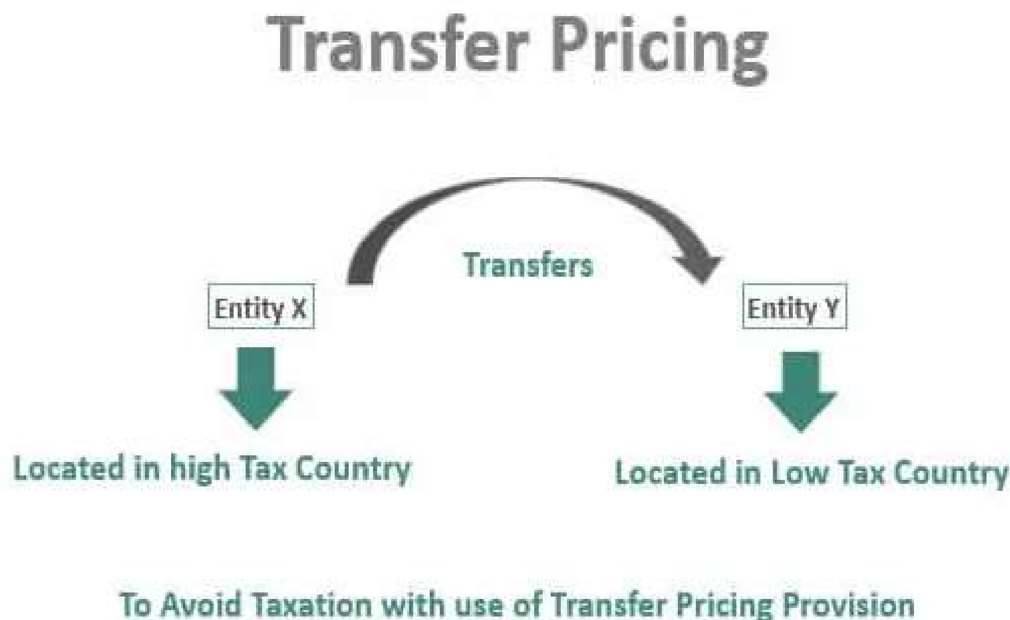
Transfer pricing is a profit allocation method used to attribute a Multi-National Enterprises net income (profit or loss) to the tax jurisdictions where it operates its subsidiary controlled foreign corporations (CFCs). The transfer price is defined as the price charged between related corporate entities for goods or services in an intercompany transaction.

Transfer pricing refers to the mechanism by which cross boarder intra-group transactions are priced. In itself, it is a normal incident of MNE operations, it allows MNE to determine which parts of the group are profitor loss-making, for example. However, if the method used to determine the price of such transactions, for whatever reason, does not reflect their true value, profits might effectively be shifted to low-tax or no-tax jurisdictions and losses and deductions to high-tax jurisdictions.

According to ICAN

"Transfer is the process of arriving at a price charged for goods and services supplied or transferred by one subunit of an organisation to another subunit or one member of a group to another. The Practice among MNEs of adjusting the price of goods and services as they move around their global operations is commonly referred to as transfer pricing is an "artificial or fictitious" transaction when not at arm's length (Mispricing) it may also be a scheme to evade or avoid tax. It is very complex, particularly in relation to Multinational Companies, although the term can also purely apply to domestic transfers".

13.1.1 Graphical presentation:



13.2 Features of the 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. Based on the above definition and analysis here are elevated key features of transfer pricing:

- **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.

- **Global Coordination and Regulations**: Transfer pricing is governed by domestic tax laws and international guidelines provided by organizations like the Organisation for Economic Co-operation and Development (OECD), ensuring consistency and cooperation across jurisdictions.

Understanding and adhering to transfer pricing regulations is crucial for multinational enterprises to maintain compliance, minimize tax risks, and ensure fair distribution of profits among related entities.

13.3 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.

13.4 Relevance of tax treaties:

The tax treaties have an important role in dealing with transfer pricing cases and examination of the transactions of MNE's and Associated Enterprises. The OECD's model treaty containing model articles are of relevance.

The double taxation avoidance agreements entered into by India with other countries incorporate provisions on the lines of the OECD model articles.

The ever-increasing focus on transfer pricing has highlighted the importance of cooperation between tax authorities of different countries under the provisions of these treaties. But there are limitations, particularly when it comes to furnishing information regarding any trade, business, industrial or professional secret or any trade process, as the tax authorities though have access to such confidential information, cannot part with such information.

13.5 Understanding Transfer Pricing:

- Transfer pricing deals with determining mark-up based on the costs. It is relevant to know the costs incurred by a business enterprise, such as transportation, packing, freight, insurance, and tax or customs charges where applicable.
- An arrangement of transfer pricing is usually between related enterprises, such as holding and subsidiary companies. The arrangement specifies the transfer price for sale or purchase of goods between the holding and subsidiary companies.
- The arrangement may be between two or more subsidiaries of the parent company, or between different companies within a group. For example, a parent company may manufacture the cars, including assembling the body and finishing job.
- Two wholly-owned subsidiaries manufacture components, such as brake lining and others. Transfer pricing helps in determining the pricing of the components between the parent company and its subsidiaries.
- Transfer pricing helps in maintaining a market for the goods manufactured by a subsidiary with steady margins. It also helps in securing a steady supply of raw materials or components to the parent and facilitates continuous production. The prices fixed for transferring goods is generally closer to the fair market price for such goods in the market.
- The system of transfer pricing is between related enterprises. Hence, it is not beneficial to sell below or above the market price of either entities or the group as a whole. If the goods are sold above or below the market price, it will lead to an uneven distribution of profits between different entities within a group.

13.6 Various aspects of transfer pricing:

Transfer pricing is an accounting and taxation practice that allows for pricing transactions internally within businesses and between subsidiaries that operate under common control or ownership. The transfer pricing practice extends to cross-border transactions as well as domestic ones.

A transfer price is used to determine the cost to charge another division, subsidiary, or holding company for services rendered. Typically, transfer prices are reflective of the going market price for that good or service. Transfer pricing can also be applied to intellectual property such as research, patents, and royalties.

Multinational corporations (MNCs) are legally allowed to use the transfer pricing method to allocate earnings among their subsidiary and affiliate companies that are part of the parent organization. However, companies sometimes can also use (or misuse) this practice by altering their taxable income, thus reducing their overall taxes. The transfer pricing mechanism is a way that companies can shift tax liabilities to low-cost tax jurisdictions.

Example: Suppose a company A purchases goods for 100 rupees and sells it to its associated company B in another country for 200 rupees, who in turn sells in the open market for 400 rupees. Had A sold it direct, it would have made a profit of 300 rupees. But by routing it through B, it restricted it to 100 rupees, permitting B to appropriate the balance. The transaction between A and B is arranged and not governed by market forces. The profit of 200 rupees is, thereby, shifted to the country of B. The goods is transferred on a price (transfer price) which is arbitrary or dictated (200 hundred rupees), but not on the market price (400 rupees).

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufacture products in a high tax country may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.

13.7 Importance of Transfer Pricing:

13.7.1 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.

13.7.2 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.

13.7.3 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.

13.7.4 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.

13.7.5 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.

It is used not only by multi-company organizations but also by entities that satisfy the conditions of associated enterprises.

13.8 Objectives of transfer pricing:

Let us understand the transfer pricing agreement through getting to know their objectives from the explanation below.

- True and fair reporting of financial statements.
- Better estimation of profits generated by entities from associated transfers.
- Avoidance of double taxation and avoiding tax evasion by entities.
- Promoting competitiveness among the associated enterprises.

13.9 Purpose of transfer pricing:

Let us understand the purpose of a transfer pricing through the discussion below.

1. Determination of a fair and equitable price of a transaction that takes place between two related enterprises involving the purchase and sale of goods and services;

2. Other purposes include accounting for a transaction as per its market price, avoiding any collusion among associated enterprises, and providing a base for estimating income generated from such transactions. Also, this concept is useful for true and fair reporting of transactions between associated enterprises in the financial statements of such entities.

13.10 Drawbacks and risks with transfer pricing:

Regardless of transfer pricing methods being useful for individuals and MNCs, it also has its share of risks and intricate detailing to it. Let us understand them through the discussion below.

- This concept functions basically on the principles of price determination that is available in the market for such commodities or services involved in the transaction.

- Due to such a function, there are few risks involved, such as the valuation of those transactions that involve the use of intellectual property, services that are highly valued, and transactions that are not of financial nature. The exchange of goods and services with unrelated goods and services between associated enterprises, etc.

- Also, there is a risk of mispricing a self-generated commodity or service that is not related to any other resource in the market due to limitations present in domestic pricing rules. This would require additional administrative costs and a time-consuming process.

- There are few limitations in determining arm's-length prices as two products cannot be compared due to the homogenous nature of such commodities or services.

Example-1:

Two associated entities X and Y, where X is situated in a high tax country. On the other hand, y is located in a Low tax country which is a tax haven destination; in this case, X would shift most of the revenue generated to Y through means of some associated transfers to avoid taxation or reduce the incidence of tax for the company, with the use of these provisions, such type of tax avoidance transactions could be eliminated. Similarly, due to this, there will not be the eradication of revenue from one country to another by benefiting the country of source of generating such revenue.

Example-2:

Coca-Cola: Because the production, marketing, and sales of Coca-Cola Co. (KO) are concentrated in various overseas markets, the company continues to defend its $3.3 billion transfer pricing of a royalty agreement. The company transferred IP value to subsidiaries in Africa, Europe, and South America between 2007 and 2009. The IRS and Coca-Cola continue to battle through litigation, and the case has yet to be resolved.

Medtronic: Ireland-based medical device maker Medtronic and the IRS met in court between June 14 and June 25, 2021, to try and settle a dispute worth $1.4 billon. Medtronic is accused of transferring intellectual property to low-tax havens globally. The transfer involves the value of intangible assets between Medtronic and its Puerto Rican manufacturing affiliate for the tax years 2005 and 2006. The court had initially sided with Medtronic, but the IRS filed an appeal. In mid-2022, the court found that Medtronic did not meet its burden of proof requirement, and the IRS abused its discretion by modifying the method.

Example -3:

The assembly division of an automobile company, ABC Company, offers to purchase 50,000 tires from the tire division of the same company for $100 per unit. The production costs per tire at a volume of 200,000 tires per year are as follows:

Item	Production Cost ($)
Direct materials	50
Direct labor	20
Variable factory overhead	12
Fixed factory overhead	42
Total	124

The tire division typically sells 200,000 tires every year to arm's length customers at $140 per unit. In addition, the capacity of the tire division is 300,000 batteries/year. The assembly division typically buys the tires from arm's length suppliers at $125 per unit.

Now, the question is whether or not the tire division manager should accept the offer? If yes, how will the company benefit from this internal transfer?

The tire division has a surplus capacity of (300,000-200,000) = 100,000 tires per year. So the relevant costs to the tire division will be $82 / battery (total of $124 minus the fixed factory overhead of $42).And the increased margin to the tire division would be 50,000*$(100 –82) = $0.9 million.

Due to the above benefits to the tire division, its manager must undoubtedly accept the offer. The assembly division pays $125 to external suppliers for a tire that could be purchased internally at an incremental cost of just $82. So, the overall cost saved by the company would be 50,000 * $(125–82) = $2.15 million per year.

This is how the company will benefit from the internal transfer.

Now, what should be the price range in this case?

The transfer price should be kept between $ 82 and $ 125. If it goes below $82, the tire division will be at a loss, while if it goes beyond $125, the assembly division will be paying more than what it pays to the external suppliers.

13.11 Transfer Pricing and Taxes:

To better understand how transfer pricing impacts a company's tax bill, let's consider the following scenario. Let's say that an automobile manufacturer has two divisions: Division A, which manufactures software, and Division B, which manufactures cars. Division A sells the software to other carmakers as well as its parent company. Division B pays Division A for the software, typically at the prevailing market price that Division A charges other carmakers.

Let's say that Division A decides to charge a lower price to Division B instead of using the market price. As a result, Division A's sales or revenues are lower because of the lower pricing. On the other hand, Division B's cost of goods sold are lower, increasing the division's profits. In short, Division A's revenues are lower by the same amount as Division B's cost savings—so there's no financial impact on the overall corporation.

However, let's say that Division A is in a higher tax country than Division B. The overall company can save on taxes by making Division A less profitable and Division B more profitable. By making Division A charge lower prices and pass those savings on to Division B, boosting its profits through a lower COGS, Division B will be taxed at a lower rate. In other words, Division A's decision not to charge market pricing to Division B allows the overall company to evade taxes.

In short, by charging above or below the market price, companies can use transfer pricing to transfer profits and costs to other divisions internally to reduce their tax burden.

13.12 Challenges of transfer pricing - India:

There are many challenges with respect to tax administration as transfer pricing is not an exact science. With increasing globalization, national borders seem less relevant to how they conduct business transaction which results in increase in mobility of assets, funds, technology, thereby increase in national- international transactions. Multinational enterprises have cross border transaction which carry on transaction in different form leading to movement of resources in different countries with different tax jurisdictions. This leads to many issues like allocation of resources, profits, valuations, taxation on profits across such jurisdiction, domestic tax law, international tax laws, sovereign political rights, tax treaties and trade analysis. Each countries' fiscal authorities have taken several steps to protect their tax bases and thereby protecting their economy. There are many more challenges like laying standard procedures, reducing the cost of compliance and developing database for fact finding relating to applicability of transfer pricing.

Indian Income tax Act introduced the provisions on transfer pricing in 2001. Transfer pricing owes its existence to the Finance Act 2001 which amended the sec 92 of the Income Tax Act and introduced new provision u/s 92A to F. The amended act brought out more clarity in terms like Multinational Enterprise (MNE) and Associated Enterprise (AE). It also provides for methods of Arms' length pricing. The provisions are exhaustive and in line with international practices. However, there are a number of disputes leading to a lot of litigation. Tax authorities have taken number of initiatives like Safe Harbor Provisions, selection of risk-based cases for TP Audit etc.

Further India is committed to implement recommendations given in Base Erosion and Profits Sharing (BEPS) Action Plan concerning Transfer Pricing. From F Y 2016-2017. TP documentation and reporting is by and large aligned with OECD BEPS planned action. The documentation to be called for require a three-level approach i.e., master file representing global business of entity along with transfer pricing policies, local file representing India entities in the group complying with ALP principles and country level representing country by country reporting business, transfer pricing policies etc. All this leads to more dynamic and transparent dealings by the company having global presence. It is of utmost importance that business houses are diligent enough while adopting transfer pricing policies and maintains enough documentation supporting the cost, pricing and valuation of goods and services involved in the transfer pricing, both with arms' length and non- arms' length parties.

Transfer pricing per se is not in itself illegal or necessary evil or abusive, but mispricing or manipulative transfer pricing is illegal or abusive.

13.13 Transfer Pricing defined by IRS:

The IRS states that transfer pricing should be the same between intercompany transactions that would have otherwise occurred had the company done the transaction with a party or customer outside the company. According to the IRS website, transfer pricing is defined as follows:

The regulations under section 482 generally provide that price charged by one affiliate to another, in an intercompany transaction involving the transfer of goods, services, or intangibles, yield results that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

13.14 Internal Revenue Service and Transfer Pricing.

As a result, the financial reporting of transfer pricing has strict guidelines and is closely watched by tax authorities. Auditors and regulators often require extensive documentation. If the transfer value is done incorrectly or inappropriately, the financial statements may need to be restated, and fees or penalties could be applied.

However, there is much debate and ambiguity surrounding how transfer pricing between divisions should be accounted for and which division should take the brunt of the tax burden.

13.15 Summery:

Transfer Pricing is a critical concept shedding light on a vital aspect of international business operations and taxation. Understanding and implementing effective transfer pricing strategies is fundamental for multinational corporations, enabling them to optimize profits, comply with tax regulations, and manage intercompany transactions. This lesson explores various methodologies, such as the arm's length principle and advanced pricing agreements, providing insights into how businesses can establish and justify their transfer pricing policies. Moreover, it emphasizes the significance of compliance with local tax laws and international guidelines to mitigate risks and maintain transparency. Ultimately, mastering transfer pricing is essential for multinational enterprises to strike a balance between profitability, legal compliance, and ethical business practices in a globalized economic landscape.

13.16 Key words:

Preferred customers: Understanding better what a preferred customer is. A preferred customer is a purchaser (buying organization) who receives better treatment than other customers from a supplier, in terms of product quality and availability, support in the sourcing process, delivery or/and prices.

Comparability Analysis: The phrase "comparability analysis" is used to designate two distinct though related analytical. Steps. An understanding of the economically significant characteristics of the controlled transaction, i.e., the transaction between associated enterprises, and of the respective roles of the parties to.

Mergers: A merger is a business deal where two existing, independent companies combine to form a new, singular legal entity. Mergers are voluntary. Typically, both companies are of a similar size and scope and both stand to gain from the transaction. Mergers happen for a variety of reasons.

Acquisition: An acquisition is a transaction wherein one company purchases most or all of another company's shares to gain control of that company. Acquisitions are common in business and may occur with or without the target company's approval. With approval, there is often a no – shop clause during the process. Although most people commonly hear about the acquisitions of large well-known companies, mergers and acquisitions (M&A) occur more regularly between small- to medium-sized firms than between large companies.

BEPS: An easy-to-understand base erosion and profit shifting example from the real world is companies that shifted ownership of valuable patents to tax haven jurisdictions to take advantage of low, or zero, tax rates.

13.17 Self – assessment questions:

1. What are the features of transfer pricing?
2. Write a note on historical prospects of transfer pricing.
3. How do you understand the transfer pricing?
4. What is importance of transfer pricing?
5. What are the drawbacks with transfer pricing?
6. Write a note on 'transfer pricing and taxes.
7. What are the challenges faced by Indian companies with transfer pricing?

13.18 Further readings:

1. "Transfer Pricing: Rules, Compliance, and Controversy" by James R. Fuller and W. Edward Robinson (Wiley)
2. "Transfer Pricing in International Business: A Management Tool for Adding Value" by K.P. Srinivasan (Springer)
3. "Transfer Pricing Handbook" by Robert Feinschreiber and Margaret Kent (Wiley)
4. "Transfer Pricing: The Institutional Environment and an Agenda for Reform" by Lorraine Eden and Oliver Old (Oxford University Press)
5. "International Transfer Pricing: A Guide for Companies and Their Advisers" by Paul W. Oosterhuis and Eduardo Baistrocchi (Kluwer Law International)
6. "Transfer Pricing Methods: An Applications Guide" by Robert Feinschreiber (Wiley)
7. "Transfer Pricing and Corporate Taxation: Problems, Practical Implications and Proposed Solutions" by Raffaele Petruzzi (Springer)
8. "Arm's Length Transfer Pricing Principles and Practices in the OECD and Developing Countries" by Roy Rohatgi (Springer)
9. "Transfer Pricing International: A Country-by-Country Guide" by Simon Webber (Bloomberg Tax)

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Lesson – 14

TRANSFER PRICES INFLUENCING FACTORS AND METHOD OF CHOICE

Learning objectives:

- ✓ To understand the various factors that have influence on transfer price
- ✓ To know the various components of selection of method
- ✓ To understand the strengths and weakness of various methods
- ✓ To understand the application of various method
- ✓ To know the best method for given situation

Stricture:

14.0 Introduction
14.1 Influencing factors
- 14.1.1 Legal Factors
- 14.1.2 Political and Social Factors
- 14.1.3 External Economic Factors
- 14.1.4 Internal Economic Factors

14.2 The process of selection of methods of transfer pricing
14.3 Components of selection
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- 14.3.3 The assets used or contributed
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- 14.6.5 When to Use the Resale Price Method

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- 14.7.2 How The Cost-Plus Transfer Pricing Method Works
- 14.7.3 Benefits & risks of the cost-plus method
- 14.7.4 Example: Accounting Consistency Issue

14.8 Transactional Net Margin Method (TNMM):
- 14.8.1 Principle
- 14.8.2 Steps

14.9 The Transactional Net Margin Method In practice
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 14.9.2 Steps to Apply TNMM for Distribution Services
 14.9.3 Strengths of the TNMM
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14.0 Introduction:

Transfer pricing is also used as a strategic tool by multinational corporations in decision making for realization of core activity goals and tax minimization and for profit maximization of their subsidiaries which operate in countries with lower tax. Because, transfer prices determined in goods and services transfers and the applicable methods used to determine those prices are crucial for achieving such goals.

14.1 Influencing factors of method of transfer pricing:

Therefore, either parent corporations or subsidiaries must consider such factors that influence those prices in determining transfer prices. The factors that affect determination of transfer prices and selection of methods in terms of parent corporations and subsidiaries are separated into four groups;

- Legal factors,
- Political and social factors,
- External economic factors,
- Internal economic factors.

14.1.1 Legal Factors:

- Tax rates and tax laws in the country in which the parent corporation operates,
- Tax-customs laws and rates in the country in which the subsidiary operates,
- Government interventions (price and quantity restrictions),
- Shares of the local partnerships,
- Principles of tax authorities,
- Financial reporting standards,
- Anti-dumping and anti-trust laws in the country in which the corporation operates.

14.1.2 Political and Social Factors:

- Confiscation and dispossession risks in the country in which the corporations operate, the corporations' ability to have well connections with the government of the country in which they operate,
- Racist policies in the country in which the corporations operate,
- Civil warfare in the country in which the corporations operate,
- Religious conflicts in the country in which the corporations operate,
- Political instability in the country in which the corporations operate,
- Human rights violations in the country in which the corporations operate.

14.1.3 External Economic Factors:

- Exchange rate controls and exchange rate fluctuations,
- Restrictions on profit and cash transfers,

- Price controls,
- Import restrictions and quotas,
- Inflation rates in the countries in which the corporations operate.

14.1.4 Internal Economic Factors:

- Market shares of corporations,
- Market structure of the countries in which the corporations operate.
- Competitiveness of the corporations,
- Performance and evaluation criteria for the corporations.

In addition to the components shown above, some authors have classified the factors that affect determination of transfer prices and selection of methods such as; organizational, environmental and financial factors. Besides those factors, size of the corporation and the share of sales to parent corporations and their subsidiaries in total sales are also known to have influence on determination of transfer prices and selection of methods.

For example, a study has indicated that big corporations utilize the market-based transfer pricing method for determining transfer prices. Nevertheless, degree of development in the country in which multinational corporations operate also influences determination of transfer prices and selection of methods. In summary, the selected transfer pricing method may depend on a country's degree of development.

14.2 The process of selection of methods of transfer pricing:

Selecting an appropriate transfer pricing method is critical for multinational enterprises to ensure compliance and fair profit allocation. The choice of method depends on the nature of the transactions, availability of comparable data, and the level of accuracy desired. Common methods include Comparable Uncontrolled Price (CUP), Cost Plus, Resale Price, Transactional Net Margin, and Profit Split. Each method involves comparing related party transactions with those of independent parties to determine arm's length pricing. The selection process requires careful consideration of functional analysis, data availability, and alignment with regulatory requirements to establish accurate and defensible transfer prices.

The selection of a transfer pricing method serves to find the most appropriate method for a particular case. Considerations involved in selecting a method can include: the respective strengths and weaknesses of each method; the nature of the controlled transaction; the availability of reliable information (in particular on uncontrolled comparable) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions. The functional analysis is a major part of selecting the transfer pricing method as it helps:

- To identify and understand the intra-group transactions;
- To identify the characteristics that would make a particular transaction or function suitable for use as a comparable;
- To determine any necessary adjustments to the comparable;
- To check the relative reliability of the method selected; and
- Over time, to determine if modification of the method is appropriate because the transaction, function, allocation of risks or allocation of assets have been modified.

14.3 Components of selection:

14.3.1 The functions performed:

The functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after sale services, supporting activities, services, advertising, financing and management, etc. The functional analysis must specify which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences;

Example: if both have inventories but Company 'A' holds inventories for a period of up to two years whereas Company 'B' holds inventories for a period of one month. The activities that add most value must be identified and should be discussed in more detail.

14.3.2 The risks undertaken:

The functional analysis should identify risks undertaken. Examples are: financial risk (currency, interest rate, funding risks etc) credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs and contract enforceability). A risk-bearing party would expect to have higher earnings than a non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes.

14.3.3 The assets used or contributed:

The functional analysis must identify and distinguish between tangible and intangible assets. Tangible assets such as property, plant and equipment have to be financed and an investment in such capital assets would usually be expected to earn a long-term return based on the use and risk level of the investment. Intangible assets are very important as substantial competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (e.g., patents, trademarks, trade names) but other intangibles with less legal protection may be equally important and valuable (e.g., know-how, trade secrets, marketing intangibles, etc).

14.3.4 Interplay of above factors:

Today, in a multinational group, operations tend to be more integrated across jurisdictional boundaries and the functions, risks and assets are often shared between entities in different jurisdictions. This makes functional analyses both more difficult and more necessary. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost of this is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of the transaction at issue, the economic circumstances of the parties and the business strategies they employ. The functional analysis helps to identify the operations that benefit a related party and require an arm's length return.

14.3.5 Selecting a method after the functional analysis:

Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions, may be considered. Transfer pricing methods typically use information on comparable; the lack of such comparable can make a particular method even one that might seem initially preferred inapplicable, and a different method more reliable. These comparable transactions are also referred to as "uncontrolled transactions" because the parties involved in the transactions are independent of each other. Although uncontrolled transactions of independent unrelated companies are usually used as comparable for transfer pricing purposes, in practice it is sometimes not possible to identify reliable comparable data in the same markets. In such cases practical solutions should be sought in good faith by taxpayers and the tax administration.

14.3.6 Solutions for cases where comparable are difficult:

- Searching for comparable in other industries where such comparable companies have similar functions, assets and risks;
- Searching for comparable in other geographical regions that share certain key similarities with the country in which a company conducts its business; and
- Using industry analyses (publicly available or conducted internally by the company) to identify profit levels that can reasonably be expected for various routine functions (e.g., production, services, distribution).

14.4 Choice of Available Methods: There are two general categories of methods.

- **Traditional Transaction Methods**,
  Comparable Uncontrolled Price,
  Cost Plus and
  Price Methods.
- **Transactional Profit Methods**
  Transactional Net Margin Method and
  Profit Split Method.
- **Other methods** which are considered to provide arm's length results;

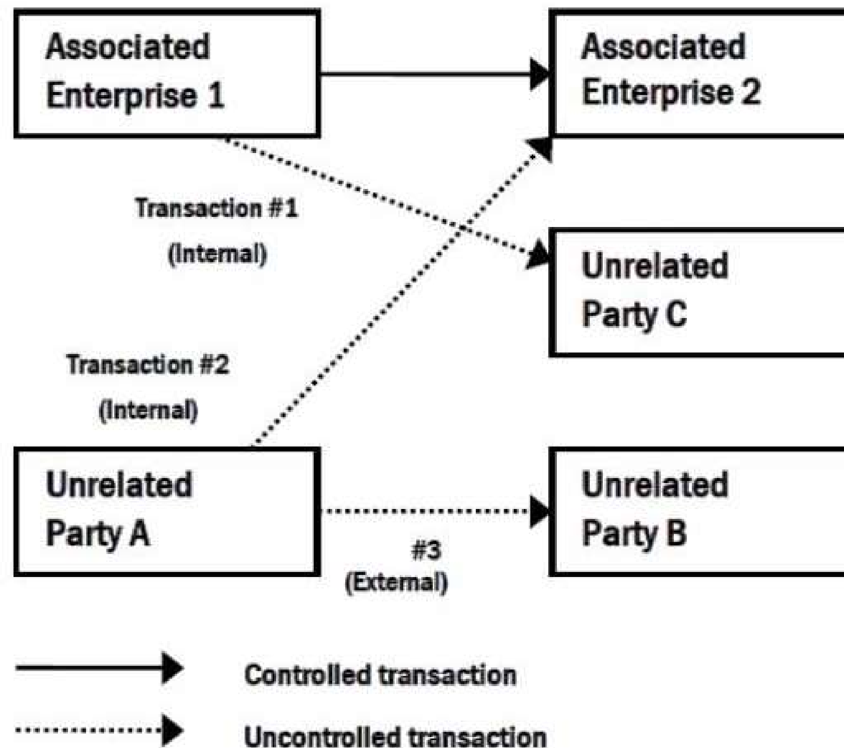
However, it needs to be ensured that such methods are consistent with the arm's length principle. The most suitable method should be chosen taking into consideration the facts and circumstances. The taxpayer should for example take into account the type of transaction, the functional analysis, comparability factors, availability of comparable transactions and the possibility of making adjustments to the data to improve comparability.Once a method is chosen and applied, taxpayers are generally expected to apply the method in a consistent fashion. Assuming that an appropriate transfer pricing method is being applied, a change in the method is typically required only if there are any changes in the facts, functionalities or availability of data.

14.4.1 Comparable Uncontrolled Price Method:

The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable

circumstances. The CUP Method may also sometimes be used to determine the arm's length royalty for the use of an intangible asset. CUPs may be based on either "internal" comparable transactions or on "external" comparable transactions. Figure 6.1 below explains this distinction in the context of a particular case study.

Comparable Uncontrolled Price Method



14.4.1.1 Analysis of the above case study:

The controlled transaction in this figure involves the transfer of bicycles between Associated Enterprise 1, a bicycle manufacturer in Country 1, and Associated Enterprise 2, a bicycle importer in Country 2, which purchases, imports and resells the bicycles to unrelated bicycle dealers in Country 2. Associated Enterprise 1 is the parent company of Associated Enterprise 2.

In applying the CUP Method to determine whether the price charged for bicycles transferred in this controlled transaction is at arm's length, the following information is assumed to be available for consideration:

- The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 1 and Unrelated Party C (i.e., transaction #1);
- The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 2 and Unrelated Party A (i.e., transaction #2); and
- The price paid for bicycles transferred in a comparable uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e., transaction #3).

Comparable uncontrolled transactions, such as transaction #1 or #2, which involve a transaction between the tested party and an uncontrolled party, are referred to as internal comparable. Comparable uncontrolled transactions such as transaction #3, which involves a transaction between two parties neither of which is an associated enterprise, are called external comparable.

14.5 Strengths and Weaknesses of the CUP Method:

14.5.1 Strengths:

1. Is a two-sided analysis as the price used reflects the agreed price between two unrelated parties to the transaction;

2. Avoids the issue of which of the related parties involved in the controlled transaction should be treated as the tested party for transfer pricing purposes;

3. Involves a direct transactional comparison of a similar transaction between unrelated parties. That is, it is a more direct measure of the arm's length price than the other methods, all of which indirectly determine arm's length prices through evaluation of the arm's length profits. As it is a more direct measure, the CUP Method is less susceptible to differences in non-transfer pricing factors (such as differences in the accounting treatment of costs between controlled and uncontrolled parties); and

4. May be more readily used in instances such as, for example, transactions involving commodity products.

14.5.2 Weaknesses:

The weakness of the CUP Method lies in the difficulty of finding comparable uncontrolled transactions in the light of the comparability standards that must be observed, particularly with respect to the comparability of products, intellectual property or services.

14.5.3 When to use the CUP Method:

- One of the associated enterprises involved in the transaction is engaged in comparable uncontrolled transactions with an independent enterprise (i.e., an internal comparable is available). In such a case all relevant information on the uncontrolled transactions is available and it is therefore probable that all material differences between controlled and uncontrolled transactions will be identified; and

- The transactions involve commodity type products, but the differences between the products are minor.

14.5.4 Example for CUP method:

MCO, a manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made free on board (f.o.b.) MCO's factory (which means the buyer takes responsibility for delivery costs of the goods for the remainder of their transit). Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. As MCO is engaged in both controlled and uncontrolled transactions, it is likely that all material differences between

the two transactions have been identified. In addition, the Comparable Uncontrolled Price Method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price. The results of this application of the Comparable Uncontrolled Price Method will therefore provide the most direct and reliable measure of an arm's length result.

14.6 Resale Price Method:

The Resale Price Method (RPM) is a transfer pricing method used to determine an arm's length price for a product or service transferred between related parties. Here's a brief explanation:

14.6.5 Principle:

The RPM is based on the principle of starting with the resale price to an independent customer and then deducting a suitable gross margin to arrive at an appropriate arm's length transfer price.

14.6.5 Steps:

- **Identify Resale Price**: Start by identifying the resale price at which the related party sells the product or service to an unrelated customer.

- **Determine Gross Margin**: Determine an appropriate gross margin that would be typical in comparable transactions between unrelated parties dealing at arm's length.

- **Adjust for Functions and Risks:** Adjust the resale price by deducting the gross margin to arrive at the arm's length transfer price, considering the functions and risks undertaken by the related parties.

- **Comparability Analysis**: Compare the gross margin applied in the controlled transaction (related party) with the gross margins from comparable transactions between independent parties to ensure consistency with the arm's length principle.

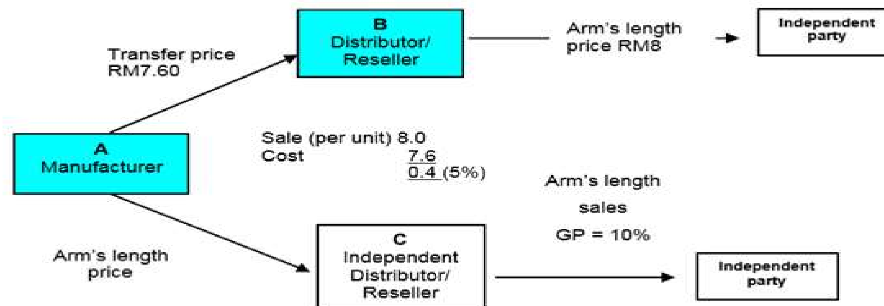
- **Data and Documentation**: Proper documentation demonstrating the selection and application of the resale price method, including details of comparable transactions and rationale for adjustments, is essential for compliance and defending the transfer pricing.

- **Applicability**: The RPM is often used in situations where a related party purchases a product or service from another related party and resells it to independent customers. It is particularly relevant in distribution and retail businesses.

The Resale Price Method provides a practical approach to establish arm's length pricing by starting with the resale price and working backwards to determine the appropriate transfer price, taking into account the related party's profit margin.

14.6.3 Example for RPM:

Taxpayer **B, a distributor,** is a Malaysian subsidiary of multinational **A**, which is located overseas. **B** distributes high quality product manufactured by **A**. **A** also sells similar product of a lower quality to an independent distributor **C** in Malaysia. The cost of product purchased from **A** by **B** is RM 7.60 per unit. **B** resells the product to independent party for RM8. A functional analysis shows that B and C perform similar functions. The gross profit ratio of **C** was found to be 10%.



In this example, it is noted that there are product (quality) differences when comparing the controlled and uncontrolled transactions. However, since the focus of comparison is on margins the differences are not as material as they would have been if the basis of comparison were on prices. Furthermore, B and C carry out similar functions (C being another reseller in the same market), thus the resale price margin of 10% will be used as a basis to determine the arm's length price for the original purchase by B from A.

Arm's length price of product purchased (in RM) = 8 – (8 X 10%) = RM 7.20.

14.6.5 Strengths and Weaknesses of the Resale Price Method:

14.6.4.1 Strengths:

- The method is based on the resale price, a market price, and thus represents a demand-driven method; in situations where there is a weak relationship between the costs incurred and the sales price of a product or services (e.g. when demand is inelastic, the resale price may be more reliable; and

- The method can be used without forcing distributors to inappropriately “make profits”. The distributor earns an arm’s length gross profit margin, however, but could have operating losses due, for example, to high selling expenses caused by business strategies such as a market penetration strategy. By comparison, the application of the Transactional Net Margin Method, which analyses a financial ratio based on operating profits, will generally result in an arm’s length range of positive operating profits. The tested party in the analysis would then probably also earn a positive operating profit within the range. However, the Resale Price Method does not necessarily result in positive operating profits to be earned by the tested party.

14.6.4.2 Weaknesses:

- It may be difficult to find comparable data on gross margins due to accounting inconsistencies; and

- The method involves a one-sided analysis, as its focus is on the related sales company as the tested party in the transfer pricing analysis. It is possible that the arm’s length gross profit margin and hence transfer price, which is based on a benchmarking analysis, can lead to an extreme result for the related supplier of the sales company (e.g., the supplier might experience a loss even though its supplier is profitable).

14.6.5 When to use the Resale Price Method:

In a typical inter-company transaction involving a "fully- fledged" manufacturer (i.e. as compared, for example, with a limited risk company or contract manufacturer) owning valuable patents or other intangible properties and affiliated sales companies which purchase and resell the products to unrelated customers, the Resale Price Method is an appropriate method to use if:

- The CUP Method is not applicable;
- The sales companies do not own valuable intangible properties; and
- Reliable comparisons can be made on COGS.

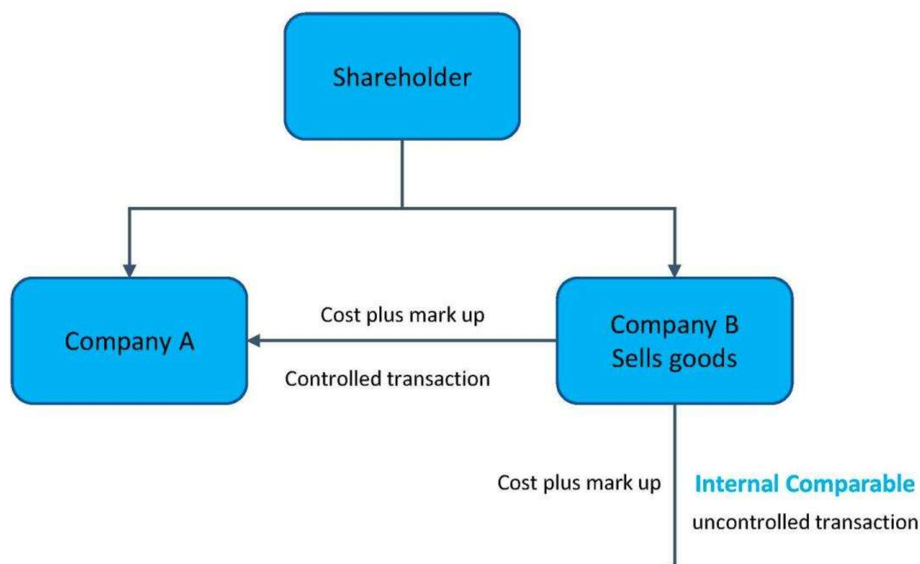
14.7 Cost - Plus Method:

In a controlled transaction involving tangible property, the Cost-Plus Method focuses on the related manufacturing company as the tested party in the transfer pricing analysis. The Cost-Plus Method may also be used in the case of services rendered.

The Cost-Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost-plus mark-up is then added to this cost, to make an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.

The Cost-Plus Method is used to analyse transfer pricing issues involving tangible property or services. It is typically most applied to manufacturing or assembling activities and relatively simple service providers. The Cost-Plus Method focuses on the related party manufacturer or service provider as the tested party in the transfer pricing analysis. The method evaluates the arm's-length nature of an inter-company charge by reference to the gross profit mark-up on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). It compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies.

14.7.1 Images of Cost plus method:



14.7.2 How The Cost-Plus Transfer Pricing Method Works:

The first step to applying this method is to determine the manufacturing costs incurred by the supplier in a controlled transaction (one made internally between related companies). Then, a market-based markup is added to that cost to account for an appropriate profit. (This is essentially the "plus" in the cost-plus method.)

To determine that a transfer price follows the **arm's length principle**, the markup is compared to the markups realized in comparable transactions made between unrelated organizations. (The arm's length principle specifies that a company must charge a similar price for an internal transaction as it would for a transaction with a third party. In other words, the transaction amount must be a fair market price.)

14.7.3 Benefits & risks of the cost-plus method:

For low-risk, routine transactions without many variables, such as the assembly and sale of tangible goods, the cost-plus method work very well. Most companies find it's relatively easy to understand and to apply, particularly because the cost-plus transfer pricing method doesn't require the same precision as the other transactional methods.

That said, there are also pitfallsespecially when comparable data isn't readily available. While similar companies may exist, there are almost always going to be differences in the way they manage their finances. An apples-to-apples comparison is absolutely critical when calculating the gross cost plus, and even minor differences in the way two companies transact and manage their cost accounting can completely distort the results of this method. In circumstances where reliable data is unavailable, a different method should be used to determine transfer prices.

14.7.4 Example: Accounting Consistency Issue:

It is assumed that Associated Enterprise 1, a bicycle manufacturer that manufactures bicycles under contract for Associated Enterprise 2, earns a gross profit mark-up of 15 per cent on its cost of goods sold and classifies certain expenses (like warranty expenses) as operating expenses that are not part of cost of goods sold. Four comparable independent manufacturers are identified which earn gross profit mark-ups between 10 to 15 per cent. However, these comparable companies account for those particular (warranty) expenses as cost of goods sold. The unadjusted gross profit mark-ups of these comparable are thus not calculated on the same basis as the gross profit mark-up of Associated Enterprise 1. Unless reliable adjustments may be made to the calculation of the gross profit mark-ups of the uncontrolled transactions or, in the alternative, of Associated Enterprise 1, for purposes of consistency, a net margin method may be more reliable.

14.8 Transactional Net Margin Method (TNMM):

The TNMM examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to be aggregated). The profit margin indicators are discussed below. The TNMM looks at the profits of one of the related parties involved in a transaction, as do the Cost-Plus Method and Resale Price Method. The party examined is referred to as the tested party.The Transactional Net Margin Method (TNMM) is a transfer pricing method used to determine an arm's length price for transactions between related parties. Here's a brief note on this method:

14.8.5 Principle:

The TNMM assesses the net profit margin relative to an appropriate base (e.g., sales, assets, or costs) earned by a taxpayer from a controlled transaction. It compares this net margin to that of comparable uncontrolled transactions to determine if the related party's profit level is within an arm's length range.

14.8.5 Steps:

14.8.5.1 Identify Comparable Companies:

Select comparable companies that engage in similar transactions with unrelated parties and calculate their net profit margins.

14.8.5.2 Compute the Net Profit Margin:

Calculate the net profit margin for the related party by considering the relevant financial data and applying the chosen base (e.g., operating costs, sales, or assets).

14.8.5.3 Compare and Adjust:

Compare the net profit margin of the related party with the range of margins observed in comparable uncontrolled transactions. If the related party's margin falls within this range, the transfer price is considered at arm's length. Otherwise, adjustments may be made.

14.8.5.4 Applicability:

The TNMM is often used when reliable comparable data is available for entities engaged in similar transactions. It is applicable to various types of transactions, including the sale of goods, provision of services, or licensing of intangible property.

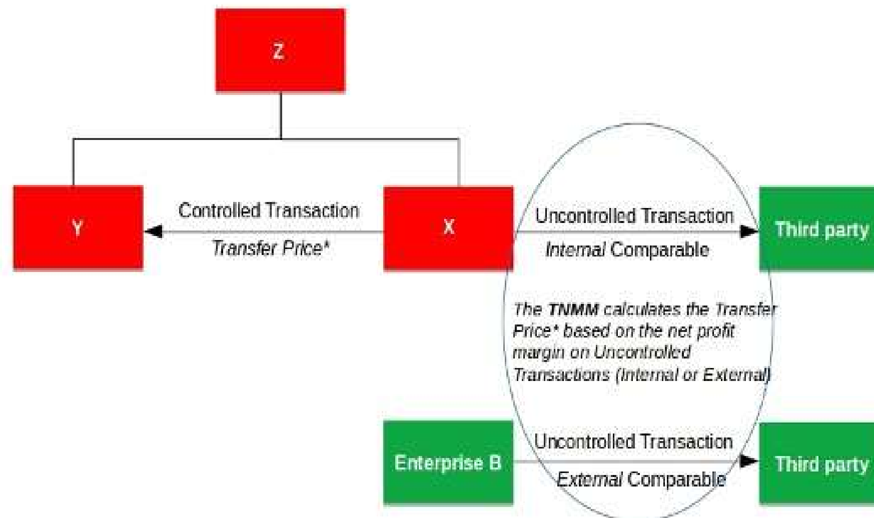
14.8.5.5 Key Considerations:

- **Comparability Factors**: Comparable companies should be selected based on factors like industry, functions performed, risks assumed, and economic conditions.

- **Functional Analysis**: A thorough functional analysis is crucial to accurately determine the net profit margin and ensure comparability.

- **Documentation and Compliance**: Comprehensive documentation that includes details of the comparable companies, financial data, adjustments, and reasoning for the selection of TNMM is essential for compliance with transfer pricing regulations.

The TNMM is a widely used transfer pricing method as it allows for flexibility in selecting comparable and considering the unique characteristics of the related party's business, making it a valuable tool in transfer pricing analysis.



14.9 The Transactional Net Margin Method In practice:

The TNMM is a good alternative for the traditional transaction methods. The fact that multiple forms of net profit indicators can be used, makes this method widely applicable. It is therefore not a surprise, that this is the most used transfer pricing method.

The TNMM can be helpful to assess the arm's length remuneration of both low-risk routine-like manufacturing and services and more complicated functions like sales or distribution. The downside of the use of the TNMM is that the level of comparability of independent transactions in some cases can be questioned. This point is often brought forward by tax authorities. However, the fact is that the TNMM is often used exactly because other transfer pricing methods cannot be applied because of a lack of comparability and / or information in the first place.

14.9.1 Example for TNMM:

Let's consider a hypothetical example of a manufacturing company in India, ABC Manufacturing Pvt. Ltd. (ABC India), and its related party, XYZ Sales Pvt. Ltd. (XYZ India), which is involved in distributing ABC India's products. We'll use the Transactional Net Margin Method (TNMM) to determine an arm's length price for the distribution services provided by XYZ India.

14.9.2 Steps to apply TNMM for Distribution Services:

- **Identify Comparable Companies:** Identify comparable Indian companies unrelated to ABC India and XYZ India, involved in similar distribution activities for comparable products.

- **Calculate Net Profit Margin**: Calculate the net profit margin for XYZ India based on its financial data. Let's assume XYZ India has a net profit of INR 2,000,000 and total sales of INR 10,000,000, resulting in a net profit margin of 20% (INR 2,000,000 / INR 10,000,000 * 100).

- **Determine Comparable Companies' Net Profit Margins**: Obtain net profit margin information for the comparable companies involved in distribution in India. Let's say the average net profit margin of the comparable companies is 18%.

- **Compare and Adjust**: Compare XYZ India's net profit margin of 20% with the average net profit margin of the comparable companies (18%). If the range of net profit margins for the comparable companies is, for example, 16% to 20%, XYZ India's net profit margin falls within the arm's length range, and no adjustments are needed.

However, if XYZ India's net profit margin is significantly higher or lower than the arm's length range, appropriate adjustments should be made to align it with the arm's length standard.

Conclusion: In this hypothetical scenario, using the TNMM for distribution services in India, we determine that XYZ India's net profit margin is within an arm's length range based on the net profit margins of comparable companies involved in similar distribution activities. This validates the transfer price for the distribution services provided by XYZ India to be at arm's length.

14.9.3 Strengths of the TNMM:

- Net margins are less affected by transactional differences than price and less affected by functional differences than gross margins. Product and functional comparability are thus less critical in applying the TNMM;
- Less complex functional analysis is needed, as TNMM is applied to only one of the related parties involved;
- Because TNMM is applied to the less complex party, it can be used even though one of the related parties holds intangible assets for which comparable returns cannot be determined;
- The TNMM is applicable to either side of the controlled transaction (i.e. to either the related party manufacturer or the distributor); and
- The results resemble the results of a modified Resale Price Method or Cost-Plus Method of analysis.

14.9.4 The weaknesses of the TNMM include the following:

- Net margins are affected by factors (e.g. variability of operating expenses) that do not have an effect, or have a less significant effect, on price or gross margins. These factors affect net profits and hence the results of the TNMM but may have nothing to do with the company's transfer pricing. It is important to consider these (non-pricing) factors in the comparability analysis;
- Information challenges, including the unavailability of information on profits attributable to uncontrolled transactions;
- Measurement challenges, these may make it difficult to determine sales revenue, operating expenses and assets relating only to the relevant controlled transactions or functions in order to calculate the selected profit level indicator. For example, if a related party distributor purchases products from both a related party and an unrelated enterprise for resale it may be impossible to determine sales revenue, operating expenses and assets attributable to only the controlled transactions to

reliably perform a net margin method of analysis. Furthermore, if the companies are engaged in different activities, it will also be very difficult to allocate sales revenue, operating expenses and assets between the relevant business activity and other activities of the tested party or the comparable. This measurement problem is an important consideration in practice;

- TNMM is applied to only one of the related parties involved. The arm's length net margin found may thus result in an extreme result for the other related parties involved in the controlled transaction (e.g. operating losses to one of the parties while the other party is guaranteed a net profit). This weakness also applies to the Cost-Plus Method and Resale Price Method but may be more important under the TNMM because net margins are affected by factors that may have nothing to do with transfer pricing. A check of the results of all related parties involved may therefore be appropriate;

- It may be difficult to "work back" to a transfer price from a determination of the arm's length net margins; and

- Some countries do not recognize the use of TNMM. Consequently, the application of TNMM to one of the parties to the transaction may result in unrelieved double taxation when the results of the TNMM analysis are not accepted for the other party. parties to the transaction may result in unrelieved double taxation when the results of the TNMM analysis are not accepted for the other party.

14.10 Summery:

"Transfer Pricing Influencing Factors and Methods of Choice" is a pivotal lesson that delves into the intricate world of transfer pricing strategies. This lesson highlights the multitude of factors that influence the establishment of transfer pricing within multinational corporations, such as tax regulations, market dynamics, organizational structure, and legal compliance. Understanding these factors is crucial in devising effective transfer pricing methods that align with a company's specific needs and goals. The lesson further explores various methodologies, including the comparable uncontrolled price method, cost-plus method, and profit split method, elucidating the nuanced selection process for the appropriate approach. By comprehending the interplay between influencing factors and methodological choices, individuals can adeptly navigate the complexities of transfer pricing, ensuring fair transactions and regulatory compliance in a global business landscape.

14.11 Key words:

Influencing factors: The influencing factors are those factors that can affect some features of target object. Influencing factors can be used as control variables to determine the key influencing factors of an object.

Comparable price: Comparable Price means, with respect to any Optional Redemption Date, (a) the average of the Reference Dealer Quotations for such Optional Redemption Date, after excluding the highest and lowest of the Reference Dealer Quotations, (b) if the Company obtains fewer than four Reference Dealer Quotations, the arithmetic average of these questions.

Uncontrolled price: The uncontrolled sales price is a delivered price whereas the controlled sales are made FOB factory. These differences in terms of transportation and

duties have an effect on price. Therefore, adjustments should be made on the uncontrolled transaction to eliminate the differences.

Cost – plus pricing: Cost plus pricing involves adding a markup to the cost of goods and services to arrive at a selling price. Under this approach, you add together the direct material cost, direct labour cost and overhead costs for a product, and add to it a markup percentage in order to derive the price of the product. Cost plus pricing can also be used within a customer contract, where the customer reimburses the seller for all costs incurred and also pays a negotiated profit in addition to the costs incurred.

Self – assessment questions:

1. What are the influencing factors of various transfer pricing methods?
2. What is the process of selection of transfer pricing method?
3. What is cost – plus method? How it works?
4. What are the strengths and weakness of TNMM?
5. Write a note on resale price method.

Further readings:

1. "Transfer Pricing Handbook: Guidance for the OECD Regulations" by Robert Feinschreiber and Margaret Kent (Wiley)
2. "Transfer Pricing in International Business: A Management Tool for Adding Value" by K.P. Srinivasan (Springer)
3. "Transfer Pricing: Rules, Compliance, and Controversy" by James R. Fuller and W. Edward Robinson (Wiley)
4. "Global Transfer Pricing: Principles and Practice" by Javier Serra, Linda G. Moleski, and Richard T. Chaifetz (John Wiley & Sons)
5. "Transfer Pricing Methods: An Applications Guide" by Robert Feinschreiber (Wiley)
6. "Transfer Pricing and Valuation in Corporate Taxation: Federal Legislation vs. Administrative Practice" by Michael Lang, Josef Schuch, Claus Staringer, and Pasquale Pistone (Springer)
7. "Practical Guide to U.S. Transfer Pricing" by Robert Feinschreiber and Margaret Kent (Wiley)
8. "Transfer Pricing: A Diagrammatic and Case Study Introduction" by Paulius Seskauskas (Routledge)
9. "Transfer Pricing and Corporate Taxation: Problems, Practical Implications and Proposed Solutions" by Raffaele Petruzzi (Springer).

Dr. K. Vanitha

Lesson -15

METHOD OF TRANSFER PRICING AND COMPARISON

Learning objectives:

- ✓ To understand the various methods of transfer pricing
- ✓ To know the method of profit split method
- ✓ To understand the comparability of different methods
- ✓ To know the legal and regularity frameworks regarding this
- ✓ To know the prime documents for transfer pricing

Structure:

15.0 Introduction
15.1 Methods of transfer pricing
15.2 Profit Split Method
    15.2.1 Model of Profit split method
    15.2.2 How the profit split method works?
    15.2.3 Methods to split the profits
    15.2.4 Strengths and Weaknesses of split the profits method
    15.2.5 When to use the Profit Split Methods
15.3 Examples: Application of Residual Profit Split
15.4 Comparable of different transfer pricing methods
    15.4.1 Comparable Uncontrolled Price
15.5 Comparability in Applying the Resale Price Method
15.6 Comparability of cost-plus method
15.7 Comparability of Transactional Net Margin Method
15.8 Comparability of Profit Split Method
15.9 Various documentations in transfer pricing
    15.9.1 Master File
    15.9.2 Local File
    15.9.3 Country-by-Country Reporting (CbCR):
15.10 Transfer Pricing Policies and Methodology
15.11 Regulatory guidelines
15.12 Summary
15.13 Key words
15.14 Self – assessment questions
15.15 Further readings

15.0 Introduction:

Transfer pricing refers to the pricing of goods, services, or intangible assets exchanged between affiliated companies, often located in different countries. It's a crucial aspect of international taxation and business strategy to ensure fair and arm's length transactions. Each transfer pricing method has its advantages and is chosen based on the specifics of the transaction, availability of comparable data, and compliance with local regulations. It's important for multinational enterprises to carefully select and document the appropriate method to ensure compliance with tax laws and regulations. Here's recapping of various methods used in transfer pricing:

15.1 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.

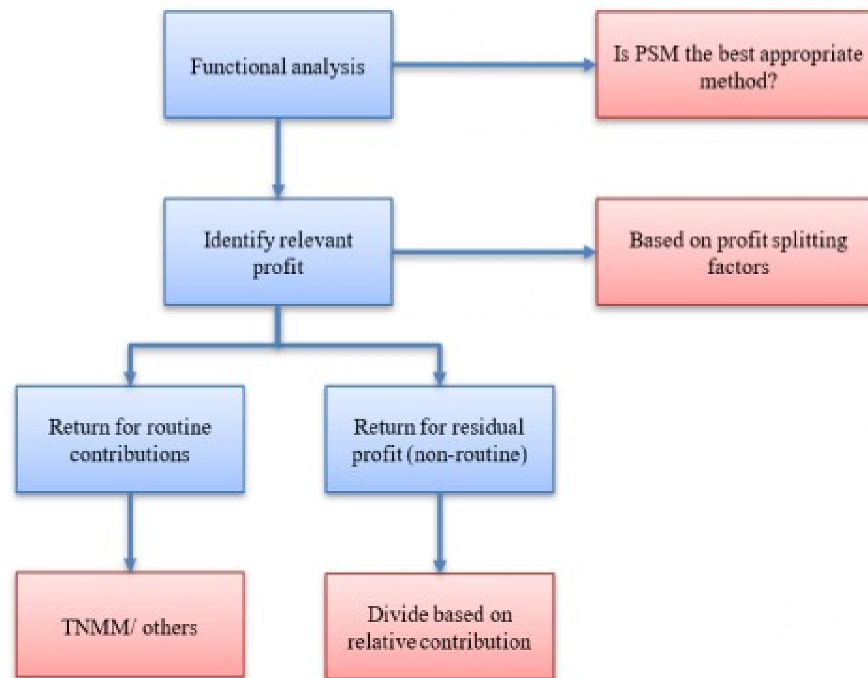
10. **Fixed or Formula-Based Methods:** These methods use predetermined formulas or fixed rates to establish transfer prices based on historical data, industry benchmarks, or other established criteria.

15.2 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.

15.2.1 Model of Profit split method:



Source: www.finance/analysis.info.co.in

15.2.2 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.

15.2.3 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.

15.2.3.1 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.

If the relative value of the contributions can be calculated directly, then determining the actual value of the contribution of each enterprise may not be required. The combined profits from the controlled transactions should normally be determined on the basis of operating profits. However, in some cases it might be proper to divide gross profits first and subsequently subtract the expenses attributable to each enterprise.

15.2.3.2 Residual analysis:

The combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach:

Step – 1: Allocation of sufficient profit to each enterprise to provide basic arm's length compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and

Step – 2: Allocation of residual profit (i.e., profit remaining after Step 1) between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intangible property, then the allocation of this profit should be based on the relative value of each enterprise's contributions of intangible property.

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 remaining after this step is attributable to the intangible properties owned by the two companies. The allocation of the residual profit is based on the relative value of each company's contributions of intangible property. The OECD Guidelines do not refer to specific allocation keys to be used in this respect. Step 2 may not, and typically does not, depend on the use of comparable.

The following approaches have been specified in some jurisdictions to determine the relative value of each company's contributions of intangible property:

- External market benchmarks reflecting the fair market value of the intangible property;

- The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible; and

- The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is roughly similar.

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.

15.2.4 Strengths and Weaknesses of split the profits method:

15.2.4.1 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.

15.2.4.2 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.

- External data with regards to profit split isn't readily available in most cases.

15.2.5 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.

15.3 Examples: Application of Residual Profit Split:

i. XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.

ii. XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.

iii. XYZ-Asia's research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2009 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.

iv. For the 2009 tax year XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia and incurs no expenses related to the marketing of Stelon in Asia. For the 2009 tax year XYZ-Asia's Stelon sales and pre-royalty expenses are $500 Million

and $300 Million, respectively, resulting in net pre-royalty profit of $200 Million related to the Stelon business. The operating assets employed in XYZ-Asia's Stelon business are $200 Million. Given the facts and circumstances, Country A's taxing authority determines that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an average market return on XYZ-Asia's operating assets in the Stelon business is 10 per cent, resulting in a market return of $20 Million (10% x $200 Million) for XYZ-Asia's Stelon business, and a residual profit of $180 Million.

v. Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 Million is attributable to the valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon formula (including XYZAsia's modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2009 on Stelon-related research and development and marketing over the 2009 sales related to such expenditures.

vi. As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the 2009 tax year.

vii. XYZ-Asia's expenditures on Stelon research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development the taxing authority capitalizes and amortizes XYZAsia's expenditures and determines that they have a value in 2009 of $0.40 per dollar of XYZ-Asia's Stelon sales.

viii. Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for 2009, of which XYZ contributed a third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm's length royalty for the Stelon license for the 2009 taxable year is $60 Million, i.e. one-third of XYZ-Asia's $180 Million in residual Stelon profit.

15.4 Comparable of different transfer pricing methods:

15.4.1 Comparable uncontrolled price:

The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP Method may also sometimes be used to determine the arm's length royalty for the

use of an intangible asset. CUPs may be based on either “internal” comparable transactions or on “external” comparable transactions.

In performing the comparability analysis, the controlled transactions and uncontrolled transactions should be compared based on the comparability factors. In determining the degree of comparability between the controlled transactions and uncontrolled transaction. The following factors should be taken into account:

characteristics of property being transferred or services provided,

i. contractual terms,
ii. economic circumstances and
iii. business strategies.

For the functional analysis it is necessary to analyse the functions performed, the risks assumed and the assets used.

Product comparability should be closely examined in applying the CUP Method. A price may be materially influenced by differences between the goods or services transferred in the controlled and uncontrolled transactions. The CUP Method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.

Although product comparability is important in applying the CUP Method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors. Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability.

15.5 Comparability in applying the Resale Price Method:

An uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences between the transactions being compared that materially affect the gross margin (for example, contractual terms, freight terms, etc); or

- Reasonably accurate adjustments can be performed to eliminate the effect of such differences.

As noted above, the Resale Price Method is more typically applied on a functional than on a transactional basis so that functional comparability is typically more important than product comparability. Product differences will probably be less critical for the Resale Price Method applied on a functional basis than for the CUP Method, because it is less probable that product differences will have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

While product differences may be more acceptable in applying the Resale Price Method as compared to the CUP Method, the property transferred should still be broadly similar in the controlled and uncontrolled transactions. Broad differences are likely to reflect differences in functions performed, and therefore gross margins earned, at arm’s length.

The compensation for a distribution company should be the same whether it sells washing machines or dryers, because the functions performed (including risks assumed and

assets used) are similar for the two activities. It should be noted, however, that distributers engaged in the sale of markedly different products cannot be compared. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under the Resale Price Method, greater product similarity is likely to provide more reliable transfer pricing results. It is not always necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the Resale Price Method can be applied more broadly, for example based on the gross margin a sales company should earn over its full range of broadly similar products.

The following issues should be considered in determining whether the functions performed by an uncontrolled entity are comparable to the functions performed by a controlled entity for purposes of applying the Resale Price Method:

- In contrast to the CUP Method, the reliability of the RPM can be influenced by factors that have less effect on the price of a product than on the costs of performing functions. Such differences could affect gross margins even if they do not affect the arm's length prices of products (e.g. the composition of COGS). These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency;

- A resale price margin requires particular attention where the reseller adds substantially to the value of the product, for example by assisting considerably in the creation or maintenance of intangible property related to the product (e.g. trademarks or trade names) or where goods are further processed into a more complicated product by the reseller before resale;

- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent;

- If the reseller performs a significant commercial activity in relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;

- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;
- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability; and

- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

15.6 Comparability of cost-plus method:

An uncontrolled transaction is considered comparable to a controlled transaction in applying the Cost-Plus Method if:

- There are no differences between the transactions being compared that materially affect the gross profit mark-up; or
- Reasonably accurate adjustments can be performed to adjust for the effect of such differences.

As with the Resale Price Method, and for the same reasons, close similarity of products in the controlled and uncontrolled transactions is less important under the Cost-Plus Method than under the CUP Method, while functional comparability (including comparability of risks assumed and assets used) is more important. However, because significant differences in products may necessarily result in significant differences in functions the controlled and uncontrolled transactions should ideally involve the manufacturing of products within the same product family.

As the gross profit mark-up remunerates a manufacturing company for performing a manufacturing function, the Cost-Plus Method necessarily requires functional comparability. If there are material differences in functions performed that affect the gross profit mark-ups achieved on the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. In general, comparability adjustments should be made on the gross profit mark-ups of the uncontrolled transactions. Sometimes the operating expenses in connection with the functions performed and risks incurred will be taken into account as differences in functions performed may be reflected in the operating expenses.

15.7 Comparability of Transactional Net Margin Method:

Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The Cost-Plus Method and the Resale Price Method are less dependent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in operating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and functional comparability than the traditional transaction methods, because net margins are less influenced by differences in products and functions. The TNMM focuses on broad product and functional comparability

However, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect net margins. Net margins may be affected by factors that have no effect, or a less significant effect, on gross margins or prices due to the variation of operating expenses between companies. These factors may be unrelated to transfer pricing.

Specific factors that may affect net margins include, but are not limited to:

- Barriers to entry in the industry;
- Competitive position;
- Management efficiency;
- Individual business strategies;
- Threat of substitute products;
- Varying cost structures (e.g. the age of plant and equipment); and
- The degree of business experience (e.g. start-up phase or mature business).

If material differences between the tested party and the independent enterprises are affecting the net margins, reasonably accurate adjustments should be made to account for such differences.

15.8 Comparability of Profit Split Method:

A different version of the Profit Split Method is used in some countries. In this version the profit is split by comparing the allocation of operating profits between the associated enterprises to the allocation of operating profits between independent enterprises participating in similar activities under similar circumstances (Comparable Profit Split Method). The major difference with the contribution analysis is that the Comparable Profit Split Method depends on the availability of external market data to measure directly the relative value of contributions, while the contribution analysis can still be applied even if such a direct measurement is not possible.

The contribution analysis and the Comparable Profit Split Method are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enterprises are often not available.

15.9 Various documentations in transfer pricing:

Transfer pricing documentation is essential for multinational enterprises to demonstrate compliance with the arm's length principle and related tax regulations. The specific documentation requirements can vary by jurisdiction, but they generally include the following key components:

15.9.1 Master File:

A high-level document providing an overview of the global business operations, including the multinational enterprise's organizational structure, business strategies, intangible property, financials, and intra-group financial transactions.

The Master File in transfer pricing is a comprehensive document providing a global overview of a multinational enterprise's operations. It includes the organization's structure, business strategies, allocation of functions, risks, and intangible assets across jurisdictions. Financial information, intercompany transactions, transfer pricing policies, and an overview of related party agreements are outlined. Additionally, it covers a summary of the industry in which the enterprise operates, significant competitors, and economic conditions impacting the business. The Master File aims to present a clear understanding of the enterprise's global value chain, facilitating efficient transfer pricing compliance and assessments by tax authorities.

15.9.2 Local File:

Detailed information specific to each country or tax jurisdiction in which the multinational enterprise operates. This includes a comprehensive analysis of intercompany transactions, financials, transfer pricing methodology applied, and comparability analysis.

The Local File in transfer pricing is a detailed document specific to each jurisdiction where a multinational enterprise operates. It contains an in-depth analysis of intercompany transactions, including product pricing, cost-sharing arrangements, and service agreements. Financial data, comparability analyses, and justifications for the chosen transfer pricing methods are included. The Local File also outlines the functional analysis, delineation of entities' roles, risks, and contributions within that specific jurisdiction. It provides a

comprehensive view of the economic environment, industry conditions, and local market dynamics influencing the transfer pricing arrangements. The aim is to ensure compliance with local tax regulations and present a thorough account of related party transactions for tax authorities in that jurisdiction.

15.9.3 Country-by-Country Reporting (CbCR):

A report providing a breakdown of the multinational enterprise's global operations, income, taxes paid, and certain indicators of the location of economic activity. This report is submitted to tax authorities in the jurisdictions where the enterprise operates.

The Country-by-Country Report (CbCR) is a document that provides a detailed breakdown of the global operations of a multinational enterprise (MNE) to tax authorities. This report includes financial information, such as revenue, profit, taxes paid, and other economic indicators, on a country-by-country basis. It offers a clear overview of the MNE's presence, operations, and economic activities in each jurisdiction.

The CbCR enables tax authorities to assess the global tax risk profile of the MNE and helps identify potential transfer pricing issues, profit shifting, and base erosion practices. This tool promotes transparency and aids in understanding the multinational's global value chain, thereby enhancing effective risk assessment and coordination among tax authorities across different jurisdictions. Ultimately, the CbCR assists in ensuring that multinational enterprises pay taxes in line with the economic substance and value they create in each country of operation.

15.10 Transfer pricing policies and methodology:

Clear documentation explaining the transfer pricing policies adopted by the company, including the chosen transfer pricing method(s), functional analysis, comparability factors, and rationale for selecting the method(s). Transfer Pricing Policies and Methodology pertain to the established guidelines and approach adopted by a multinational enterprise (MNE) for determining arm's length prices for transactions between related parties. It involves the following components:

- **Method Selection**: Identification and selection of appropriate transfer pricing methods based on the nature of transactions, industry, and available data. Common methods include Comparable Uncontrolled Price (CUP), Cost Plus, Resale Price, Transactional Net Margin, and Profit Split.

- **Functional Analysis**: In-depth assessment of functions performed, risks assumed, and assets utilized by each related party involved in the transactions. Understanding the value creation process and contributions of each entity in the value chain.
- **Comparability Factors**: Criteria used to identify comparable uncontrolled transactions or companies for benchmarking purposes. Factors such as industry, products, functions, market conditions, and geographic location are considered.

- **Arm's Length Range Determination**: Establishing an arm's length range by comparing the controlled transactions with comparable uncontrolled transactions. This involves analyzing financial and economic data to ascertain a fair range of pricing.

- **Risk Assessment and Allocation**: Evaluating the risks associated with various entities in the transactions and determining an appropriate allocation of risks in line with the arm's length principle.

- **Intangible Property Valuation**: Methods and principles applied to value and allocate costs or income associated with intangible assets like patents, copyrights, trademarks, and proprietary technology.

- **Intra-Group Services and Cost Allocation**: Guidelines for determining the costs of services provided among related parties and the appropriate allocation keys for fair pricing.

- **Documentation and Record-Keeping**: Procedures for documenting all relevant transfer pricing policies, methodologies, analysis, and supporting data in compliance with regulatory requirements.

- **Consistency and Compliance**: Ensuring consistency in applying transfer pricing policies across different jurisdictions where the MNE operates, in accordance with local laws and international standards.

- **Review and Updating**: Regular review of transfer pricing policies and methodologies to ensure relevance, effectiveness, and alignment with changes in business operations, regulations, and market conditions.

These policies and methodologies provide a structured framework for the MNE to establish, apply, and defend its transfer pricing practices, aiming to align the pricing of intercompany transactions with the arm's length principle and regulatory guidelines.

15.11 Regulatory guidelines:

1. **Functional Analysis**: Detailed descriptions of the functions, assets, and risks (FAR) undertaken by the parties involved in the controlled transactions. This includes an analysis of how value is created and allocated among related parties.

2. **Comparability Analysis**: A thorough comparison of the controlled transactions with uncontrolled transactions or entities to establish the arm's length range. This includes the selection and analysis of comparable companies, adjustments made, and economic and industry analyses.

3. **Documentation of Intangible Assets:** Information related to intangible assets, such as patents, trademarks, copyrights, and proprietary technologies, including their development, ownership, and valuation.

4. **Documentation of Intra-Group Services**: Detailed documentation regarding intra-group services, outlining the nature, benefits, costs, and allocation keys used for charging or providing such services.

5. **Intercompany Agreements**: Written agreements or contracts outlining the terms and conditions of the controlled transactions, aligning with the arm's length principle. These agreements should reflect economic substance and commercial rationale.

6. **Financial Data and Analysis**: Comprehensive financial information, including financial statements, budgets, and forecasts, supporting the transfer pricing analysis for each related party transaction.

7. **Risk Assessment and Management**: Documentation related to risk assessment, identification, and management strategies for transfer pricing risks, including any risk-sharing arrangements or guarantees.

8. **Documentation of advance pricing agreements (APAs):** If applicable, documentation related to any Advance Pricing Agreements (APAs) in place, detailing the agreed-upon transfer pricing methodology and terms with tax authorities.

Documentation of Advance Pricing Agreements (APAs) involves creating a formal record outlining agreed transfer pricing terms between a multinational enterprise (MNE) and tax authorities. It includes the methodology, principles, and basis for determining arm's length prices for specified transactions in advance. The APA documentation demonstrates compliance with tax regulations and provides transparency regarding transfer pricing practices. It typically includes detailed functional analysis, selection of appropriate transfer pricing methods, comparability factors, and relevant financial data. The goal is to minimize transfer pricing disputes by securing an agreed-upon approach with tax authorities prior to transactions, ensuring certainty and consistency in transfer pricing across jurisdictions.

It's important for multinational enterprises to maintain accurate, complete, and contemporaneous transfer pricing documentation to support their transfer pricing policies and positions. Adhering to these documentation requirements helps ensure compliance with local tax regulations and reduces the risk of transfer pricing disputes and penalties.

15.12 Summary:

Transfer pricing refers to the pricing of goods, services, or intangible assets exchanged between affiliated companies, often located in different countries. One of the most important methods of transfer pricing is profit split method. Implementation of this method is very simple and understanding the comparability is also an easy task. This area of knowledge has maintained with maintain of proper records like master files and local files. It is very essential that understand the regulatory frameworks which having influence on transfer prices.

15.13 Key words:

Residual: The remaining after the greater part or quantity has gone. In finance Residual value is the projected value of a fixed asset when it's no longer useful or after its lease term has expired.

Master file: A collection of records pertaining to one of the main subjects of an information system, such as customers, employees, products and vendors. Master files contain descriptive data, such as name and address, as well as summary information, such as amount due and year-to-date sales. Contrast with transaction file.

Local file: A local file refers to a file that is stored on a device, such as a computer or phone, rather than on a remote server or.

Comparability Factors: The compressibility factor **(z)** is a correction factor which describes the deviation of real gas from ideal gas behaviour. It is useful thermodynamic property for modifying the ideal gas law to account for real gas behaviour.

Functional Analysis: functional analysis, Branch of mathematical analysis dealing with functionals, or functions of functions. It emerged as a distinct field in the 20th century, when it was realized that diverse mathematical processes, from arithmetic to calculus procedures, exhibit very similar properties.

Intangible Property: The term intangible personal property refers to an item of value that cannot be touched or physically held. These assets can be held by both individuals and corporations. Intangible personal property can be anything that has image, social, and reputational capital, along with digital, copyrights, patents, and investments. Intangible personal property or intangible assets are the opposite of tangible personal property, which can be physically touched and come with a degree of value, such as machinery, jewelry, and electronics.

APAs: The concept of Advance Pricing Agreement (APA) has been introduced in India. The Central Board of Direct Taxes has recently notified advance pricing agreements scheme. Given the numerous transfer pricing cases in dispute, introduction of APAs is expected to considerably alleviate the uncertainty regarding arm's length pricing of international transactions.

Self – assessment questions:

1. What are various methods of transfer pricing?
2. What is profit splitting method? Write its features.
3. How profit split method works?
4. What are the methods of split the profits?
5. What are the strengths and weaknesses of profit splitting method?
6. Write a note on comparability in applying of resale price method.
7. What type of documents are required for transfer pricing?
8. Write a note on transfer pricing methodology.

Further readings:

1. "Transfer Pricing Handbook: Guidance for the OECD Regulations" by Robert Feinschreiber and Margaret Kent (Wiley)
2. "Transfer Pricing Methods: An Applications Guide" by Robert Feinschreiber (Wiley)
3. "Transfer Pricing: A Practical Guide for Multinational Companies" by Philip de Homont, Eduard Sporken, and Jacques Sasseville (Kluwer Law International)
4. "Transfer Pricing and Valuation in Corporate Taxation: Federal Legislation vs. Administrative Practice" by Michael Lang, Josef Schuch, Claus Staringer, and Pasquale Pistone (Springer)
5. "Practical Guide to U.S. Transfer Pricing" by Robert Feinschreiber and Margaret Kent (Wiley)
6. "Transfer Pricing and Corporate Taxation: Problems, Practical Implications and Proposed Solutions" by Raffaele Petruzzi (Springer)

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Lesson – 16

METHODS IN PRACTICE: FIXATION OF MINIMUM TRANSFER PRICE

Learning objectives:

- ✓ To understand the process of transfer pricing
- ✓ To know the various regulations on transfer pricing
- ✓ To understand the practice of transfer pricing in India
- ✓ To know the concept of minimum transfer pricing

Structure:

16.0 Introduction
16.1 Different aspects of transfer pricing
16.2 Steps in practice of transfer pricing
16.3 Approaches for implementation of transfer pricing
16.3.1 Head in the Sand Approach
16.3.2 Comprehensive Analysis Approach
16.4 Parameters to substantiating transfer pricing
16.4.1 Size of business
16.4.2 Profitability Ratios
16.4.3 International Ratios
16.4.4 Other Criteria
16.5 OCED guidelines for transfer pricing
16.6 Transfer pricing systems are made to achieve the following objectives
16.7 Three general methods for establishing transfer prices in India
16.8 Transfer pricing – Regulatory framework in India
16.8.1 Section 92-92F of the Income Tax Act, 1961
16.8.2 Rule 10AB - Determination of Arm's Length Price
16.8.3 Form 3CEB - Transfer Pricing Audit Report
16.9 Prerequisites for implementation of transfer pricing
16.10 Documentation for transfer pricing
16.10.1 Master File and Country-by-Country Reporting (CbCR)
16.10.2 Advance Pricing Agreements (APAs)
16.10.3 Safe Harbor Rules (SHR)
16.10.4 Documentation Requirements
16.11 Penalty Provisions
16.12 Dispute Resolution Mechanisms
16.13 Fixation of minimum transfer pricing
16.14 How to Find the Minimum Transfer Price?
16.14.1 Factoring in Opportunity Costs
16.14.2 Spare capacity
16.14.3 No spare capacity
16.15 Process of fixation of transfer pricing
16.16 Establishment of minimum transfer price
16.17 Minimum Transfer Price and Tax Regulations
16.18 Summary
16.19 Key words
16.20 Self – assessment questions
16.21 Further readings

16.0 Introductions:

Transfer pricing is a fundamental aspect of international business involving the pricing of transactions between affiliated or related entities within a multinational corporation. It pertains to the determination of prices for goods, services, or the use of intangible assets that are exchanged between these related parties. The key objective of transfer pricing is to ensure that these transactions are conducted at arm's length, mimicking the prices that would prevail in transactions between unrelated, independent entities.

The term "arm's length" implies that the prices or terms set in transactions between related entities should be consistent with what would be agreed upon between unrelated parties in similar circumstances. This principle helps prevent tax evasion and profit shifting by multinational corporations and promotes fairness and accuracy in assessing taxable income across different jurisdictions.

16.1 Different aspects of transfer pricing:

The practice of transfer pricing involves several critical components. One should go through the following aspects for better implementation of transfer pricing:

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.

16.2 Steps in practice of transfer pricing:

Transfer pricing involves a structured approach that considers the specific circumstances of the related parties involved, the nature of the transactions, and the available data. Here's a step-by-step guide to practicing different transfer pricing methods:

1. **Understand the Business and Transactions**: a. Gain a thorough understanding of the business operations, including functions performed, assets used, and risks assumed by each related entity involved in the transactions. b. Identify the types of transactions (e.g., sale of goods, provision of services, use of intangibles) that require transfer pricing analysis.
2. **Collect and Analyse Data:** a. Gather financial and operational data from relevant parties, including pricing information, cost structures, and market benchmarks. b. Analyse the data to identify comparable transactions and assess the comparability of these transactions.
3. **Select Appropriate Transfer Pricing Method:**
   a. Evaluate which transfer pricing method(s) is most suitable based on the nature of the transactions and the availability of reliable data. Common methods include:
   - Comparable Uncontrolled Price (CUP) method
   - Cost Plus method
   - Resale Price method
   - Profit Split method
   - Transactional Net Margin Method (TNMM)
   - Comparable Profit Split Method (CPSM)

   b. Consider using multiple methods for a comprehensive analysis.

4. **Perform Benchmarking Analysis**: a. Apply the selected transfer pricing method(s) using the collected data and industry benchmarks. b. Adjust for any differences between the controlled transactions and the comparable uncontrolled transactions, ensuring the arm's length principle is met.
5. **Document the Transfer Pricing Analysis**: a. Prepare comprehensive documentation that explains the selection of the transfer pricing method(s), the data used, adjustments made, and the rationale for the results. b. Include a functional analysis, economic analysis, and a comparability analysis.
6. **Consider Advance Pricing Agreements (APAs):** a. Evaluate the possibility of entering into APAs with relevant tax authorities to provide upfront certainty and agreement on the transfer pricing methodology.
7. **Engage Professionals and Seek Legal Advice:** a. Consider involving transfer pricing specialists or consultants to ensure accuracy and compliance with regulations. b. Seek legal advice to ensure compliance with local and international laws and regulations related to transfer pricing.
8. **Maintain Documentation Compliance**: a. Regularly update and maintain transfer pricing documentation in compliance with local regulations, ensuring it reflects any changes in the business or the market environment. b. Be prepared for potential tax audits and ensure all documentation is readily accessible and organized.
9. **Monitor and Adjust Transfer Pricing Policies**: a. Monitor the effectiveness of the transfer pricing policies and methodologies over time, making adjustments as needed to align with changing business circumstances and regulatory requirements.
10. **Ensure Global Consistency:** a. Aim for consistency in transfer pricing policies across various jurisdictions to minimize the risk of disputes and maintain a cohesive global tax strategy.

By following this structured approach and considering the unique aspects of each transfer pricing method, businesses can effectively practice and implement appropriate transfer

pricing strategies. It's essential to stay informed about evolving regulations and best practices in the field of transfer pricing to ensure compliance and minimize risks.

16.3 Approaches for implementation of transfer pricing:

Many transfer pricing strategies are available. Before you dwell on the morass of new transfer pricing rules in depth, it might be advantageous for you to assess where your company fits, or should fit, in the spectrum of strategies.

16.3.1 Head in the Sand Approach:

One approach to transfer pricing is to do nothing, stand pat. As one taxpayer stated, "We have some sand, and we're looking for an ostrich. We don't understand the tax rules, and neither does the IRS. We don't want to rock the boat, or provide the IRS with a roadmap to our company with the documentation we prepare. The preamble to the new transfer pricing regulations says that the 'estimated average annual burden per recordkeeper is 0.8 hours,' and we will be devoting just that amount, 48 minutes per year, to transfer pricing."

16.3.2 Comprehensive Analysis Approach:

Some companies are implementing a full-blown comprehensive approach to transfer pricing, creating and developing a team of decision makers and other resource people, both within and without the company itself. More than 30 categories of professionals could be included in the transfer pricing team, including the following:

a. **Accountants:**
   i. **Accounts payable accountants.** To review credit and collection strategies, a process needed to compare transactions.
   ii. **Controllers**. Operations executives providing the database to develop and defend transfer pricing**.**
   iii. **Cost accountants**. To develop the bulwark of the database needed to apply the resale price method or the cost-plus method
   iv. **Financial accountants**. Using FAS and SEC accounting rules to prepare a database needed for comparative purposes
   v. **Tax accountants.** To prepare the documentation for the tax return

b. **Attorneys:**
   i. **Contract attorneys.** An analysis of contracts and terms is mandatory for transfer pricing purposes. **Customs attorneys**. The cost of tariffs and tax costs should be considered together for transfer pricing purposes.
   ii. **Intellectual property attorneys**. Ascertaining the scope of intangible property may be significant; licensing is an important facet of transfer pricing.
   iii. **Litigation attorneys**. Discovery procedures and confidentiality are needed long before litigation is contemplated.
   iv. **Tax attorneys**. Interface between the other attorneys and the accountants Trade attorneys. Countervailing duties and dumping should be considered together with taxation.

c. **Computer programmers.** To implement record retention and prepare analytical reports

d. **Customs specialists.** Customs documentation is important evidence for tax purposes.

e. **Economists**.

   i. **Economic geographers**. To prepare analysis between countries, sometimes needed for comparative purposes
   ii. **Microeconomists.** Difference analysis is at the heart of transfer pricing analysis, preparing the viability of comparable transactions.
   iii. **Macroeconomists.** To select the database; to cope with business cycles as they affect transfer pricing

f. **Employee benefits specialists.** Fringe benefits might affect costing to determine the gross profit markup or gross profit.

g. **Engineers**
   i. **Engineering economists.** To interface between production engineers and process engineers and economists
   ii. **Production engineers.** To determine functions of the company
   iii. **Process engineers.** To determine functional analysis

h. **Financial analysts.** To review financial reporting prepared by the company's competitors, to determine comparable ratios.

i. **Industry specialists.** Persons who know what is going on in the industry, developing market share analysis

j. **Marketing specialists.** To assess the advertising, marketing, and sales functions of the company

k. **Mathematical statisticians.** To determine the relevant range of transactions for comparability analysis.

l. **Personnel.** To obtain job descriptions needed to determine functions performed Operational analysts. Developing procedures that explain how the company works.

m. **Risk analysts**. To prepare the mandatory analysis of risk and exposure
n. **Tax specialists.**
   i. **International tax specialists.** Interrelationship with foreign tax credit, allocation and apportionment procedures, foreign sales corporation, foreign reporting procedures in the country, reporting of income to foreign jurisdictions
   ii. **State tax specialists**. States can impose transfer pricing rules; coordination of federal and state rules may be needed.
   iii. **Foreign tax specialists**. Foreign taxes are essential to the overall transfer pricing equation

o. **Treasurer.** Prepare international currency and hedging analysis, which is required under the tax rules

16.4 Parameters to substantiating transfer pricing:

The approach of one size fits all does not appear to be viable for the tax facets of transfer pricing. Instead, your company's approach may depend on the size of the business, certain empirical ratios, and other criteria. The following parameters pertaining to business size, profitability, international ratios, and other criteria should be helpful.

16.4.1 Size of business:

Revenue, income, and assets are factors that could be relevant in assessing the depth and magnitude of your company's transfer pricing approach, including the following facets:

- Total worldwide sales
- Total worldwide income
- Sales in the country
- Income from sales in the country
- Imports to the country
- Income from imports to the country
- Intercompany sales—imports and exports
- Income attributable to intercompany sales
- Assets in the Country
- Worldwide assets

In general, the higher the magnitude of these numbers, the more likely it is that the company should consider the comprehensive analysis approach.

16.4.2 Profitability Ratios:

A company may find it advantageous to devote more effort to establishing and reviewing transfer pricing when a profitability factor or similar ratio is high and to curtail transfer pricing efforts when these factors are low. Here, high profitability might be 15 percent, using the high-profit test within the foreign reporting regulations, which relies on the return on assets. The transfer pricing methods provide for the comparable profits' method, and the taxpayer should consider its three methods in deciding upon the level of effort it should undertake. These ratios are the final three of those following:

- Profits divided by sales
- Return on assets
- Rate of return on capital employed
- Operating income divided by sales
- Gross profit divided by operating expenses

16.4.3 International Ratios:

Transfer pricing audits in the country are more likely if the foreign portion of total activities is larger. The following ratios should be considered:

- Imports into the country divided by country sales
- Intercompany sales divided by country sales
- Country connected products or services (export and import) divided by total gross revenue.

16.4.4 Other Criteria:

A company could use criteria other than the size of the business, profitability, or international ratios to assess the potential transfer pricing exposure. Additional criteria could include the following:

- **The industry.** Companies that are in industries that are subject to scrutiny by the IRS such as automobiles, electronics, financial services, and others

- **Notoriety**. Companies in which the media would be interested, whether because of the product or service, or because the company has a large number of shareholders or a large number of consumers, or the company has received present or prior publicity.

- **Nationality of the company.** Especially companies in which the headquarters are in a country that has a large surplus with the country.

- **Location of subsidiaries.** The presence of tax haven subsidiaries makes the entire operations of the company suspect.

- **Prior tax history.** Including tax adjustments, recurrent country net operating losses

16.5 OCED guidelines for transfer pricing:

The Organisation for Economic Co-operation and Development (OECD) provides comprehensive guidelines on transfer pricing through its "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations." These guidelines offer a framework for governments and businesses to ensure that transactions between related entities are priced in line with the arm's length principle. Here's a brief overview:

- **Introduction and General Principles**: Emphasizes the arm's length principle as the core concept in determining transfer prices for related-party transactions.

- **Methods for Determining Transfer Prices:** Discusses various transfer pricing methods, including the Comparable Uncontrolled Price (CUP), Cost Plus, Resale Price, Profit Split, Transactional Net Margin Method (TNMM), and Comparable Profit Split Method (CPSM).

- **Comparability Analysis**: Provides guidance on conducting a comparability analysis to identify and evaluate comparable transactions, adjustments, and factors affecting comparability.

- **Special Considerations for Intangible Property**: Focuses on transfer pricing issues related to intangibles, providing guidance on valuation, control over risks, and use of intangibles in cost contribution arrangements.

- **Intra-Group Services, Cost Contribution Arrangements, and Low Value-Adding Intra-Group Services:** Addresses transfer pricing for intra-group services, cost-sharing arrangements, and low-value services, emphasizing the need for documentation and the arm's length principle.

- **Transfer Pricing Documentation and Country-by-Country Reporting**: Provides guidelines on documentation requirements, master file, local file, and country-by-country reporting to enhance transparency and facilitate effective risk assessment.

- **Transfer Pricing Aspects of Business Restructurings**: Focuses on the transfer pricing implications of business restructurings, emphasizing the arm's length principle and functional analysis in such scenarios.

- **Transfer Pricing Aspects of Intra-Group Financial Transactions:** Provides guidance on pricing of intra-group financial transactions, highlighting the importance of accurately delineating the financial transactions and applying appropriate pricing methods.

- **Administration and Compliance**: Addresses administrative aspects of transfer pricing, including risk assessment, dispute resolution mechanisms, advance pricing agreements (APAs), and mutual agreement procedures (MAPs).

- **Consistency and Use of Estimates**: Emphasizes the importance of consistency and proper use of estimates in applying transfer pricing methods and documenting transactions.

The OECD Transfer Pricing Guidelines serve as a fundamental reference for tax administrations and multinational enterprises, providing a framework for a consistent and principled approach to transfer pricing practices globally. It's crucial for multinational corporations and tax professionals to be well-versed in these guidelines to ensure compliance with international transfer pricing standards.

16.6 Transfer pricing systems are made to achieve the following objectives:

- To provide each division with relevant information required to make the best possible decisions for the organization as a whole;

- To promote goal correspondence: that is, actions by divisional managers to optimize divisional performance should automatically optimize the firm's performance;

- To facilitate measuring of divisional performances: It is useful for evaluating the economic performance of divisions and the managerial performance of division managers.

- To ensure that divisional autonomy is maintained: In principle, the top management of the company could simply issue precise instructions to divisions as to what goods to transfer to each other, in what quantities and at what prices. However, most of the organizations are unwilling to do this because of the enormous benefits of allowing divisional autonomy.

- To evaluate a division manager's performance, based on the profits that he generates,

- To help coordinate the divisions' decisions to achieve the organization's goals - i.e. to ensure goal consensus.

- To enable the divisions to take decisions such as the pricing of the final Product.

- To preserve the divisions' autonomy.

16.7 Three general methods for establishing transfer prices in India:

1. **Market-based transfer price**: In the presence of competitive and stable external markets for the transferred product, many firms use the external market price as the transfer price.

2. **Cost-based transfer price:** The transfer price is based on the production cost of the upstream division. A cost-based transfer price requires that the following criteria be specified:

    a. Actual cost or budgeted (standard) cost.

b. Full cost or variable cost.
c. The amount of mark-up, if any, to allow the upstream division to earn a profit on the transferred product.

3. **Negotiated transfer price**: The senior management does not specify the transfer price. Instead, divisional managers negotiate a mutually-agreeable price.

16.8 Transfer pricing – Regulatory framework in India:

In India, TP Regulations were first introduced in 2001, as a measure against tax avoidance. The Indian TP Regulations are largely influenced by the said OECD TP Guidelines, but they are modified specifically meet the needs of the Indian tax regime. Similar to the OECD Guidelines and TP Regulations of several other countries, Indian TP Regulations prescribe methods to compute 'Arm's Length Price' for an 'International Transaction' or a 'Specified Domestic Transaction' entered into by a taxpayer with its 'Associated Enterprise'.

A transfer price is what one part of a company charges another part of the same company for goods or services. It is a mechanism for distributing revenue between different divisions which jointly develop, manufacture and market products and services. Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services or the use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing exists to communicate data which will lead to goal-achieving decisions and also to evaluate performance and motivate managers to make goal-achieving decisions. The objective of international transfer pricing focuses on minimizing taxes, duties, and foreign exchange risks, along with enhancing a company's competitive position and improving its relations with foreign governments. Transfer pricing is a recent corporate tax happening in India. Prompted by the growing participation of multinationals in India, the government introduced "transfer pricing" regulations in the Finance Act of 2001 to ensure that Indian companies report "reasonable, fair and equitable" profits and taxes on transactions with "associated enterprises" such as a foreign parent company. When one subsidiary of a corporation in one country sells goods, services or know-how to another subsidiary in another country, the price charged for these goods or services is called the transfer price. All kinds of transactions within corporations are subject to transfer pricing, including those involving raw material, finished products and payments such as management fees, intellectual property royalties, loans, interest on loans, payments for technical assistance and know-how and other transactions. The rules on transfer pricing Require MNCs to conduct business between their affiliates and subsidiaries on an 'arm's length' basis, which means that any transaction between two entities of the same MNC should be priced as if the transaction was conducted between two unrelated parties.

The India has a comprehensive regulatory framework governing transfer pricing, primarily governed by the Income Tax Act, 1961, and the rules prescribed thereunder. The key regulatory provisions related to transfer pricing in India include:

16.8.1 Section 92-92F of the Income Tax Act, 1961:

Section 92 of the Income Tax Act, 1961, mandates that any international or specified domestic transactions between associated enterprises should be at arm's length to prevent tax

evasion or avoidance. This ensures fairness in transactions and determines the appropriate transfer price to prevent undue tax benefits.

Section 92F provides definitions and explanations related to transfer pricing terms used in the Act, establishing a clear framework for interpretation and application. These definitions aid in calculating arm's length prices and assist tax authorities in scrutinizing transactions to maintain tax transparency and accuracy.

16.8.2 Rule 10AB - Determination of Arm's Length Price:

Rule 10AB under the Income Tax Act, 1961, details the manner of determination of the arm's length price for international transactions and specified domestic transactions. It prescribes methods for computation, including traditional methods, transactional net margin method, and other methods accepted by the tax authorities. The rule emphasizes the importance of comparability analysis, requiring adjustments for differences that affect the price or margin in comparable transactions. It also advocates functional and risk analysis, ensuring alignment with the OECD guidelines for transfer pricing. Overall, Rule 10AB provides a structured approach to ascertain arm's length prices, promoting fairness and accuracy in cross-border and domestic transactions.

16.8.3 Form 3CEB - Transfer Pricing Audit Report:

Form 3CEB is a crucial document under the Income Tax Act, 1961, related to transfer pricing regulations. It's essentially a Transfer Pricing Audit Report that must be furnished by entities engaging in specified domestic and international transactions, ensuring compliance with transfer pricing provisions. Key details in Form 3CEB include:

a. **Entity Information**: Basic details of the assessee, its address, PAN (Permanent Account Number), etc.

b. **Nature of Business**: Description of the business activities carried out by the assessee.

c. **Details of International Transactions or Specified Domestic Transactions**: Comprehensive information on the nature, value, and terms of transactions with associated enterprises.

d. **Transfer Pricing Methodologies**: Explanation and selection of the transfer pricing method applied to determine arm's length pricing.

e. **Economic Analysis**: Detailed economic analysis supporting the arm's length nature of the transactions.

f. **Compliance with Legal Provisions**: Confirmation of compliance with the transfer pricing regulations under the Income Tax Act.

g. **Details of Accountant and Audit**: Information about the Chartered Accountant conducting the audit and any other relevant details.

h. **Penalties and Prosecution**: Declaration regarding penalties, prosecution, or any other consequences under the Act.

Form 3CEB is crucial for assessing whether transactions with associated enterprises are conducted at arm's length prices and in compliance with tax regulations. It aids tax authorities

in evaluating the legitimacy and fairness of these transactions, ensuring appropriate taxation and prevention of tax evasion or avoidance.

16.9 Prerequisites for implementation of transfer pricing:

Comprehensive documentation detailing related-party transactions and pricing methodologies. Pricing in line with the arm's length principle, ensuring transactions are at fair market value. Understanding and compliance with applicable thresholds for related-party transactions triggering transfer pricing regulations. Adherence to Indian transfer pricing regulations outlined by the Income Tax Act and Rules. Familiarity with acceptable transfer pricing methods like Comparable Uncontrolled Price, Cost Plus, Resale Price, etc. Maintaining contemporaneous documentation to support transfer pricing methodologies and values. A thorough analysis of functions, assets, and risks associated with the transactions. Conducting a robust economic analysis to justify the chosen transfer pricing method. In-house or external expertise to understand complex transfer pricing regulations and methodologies. Ensuring consistency in transfer pricing policies across group entities and compliance with evolving regulatory guidelines. Keeping proper records of financial and operational data relevant to transfer pricing. Availability of accurate and reliable data for benchmarking purposes. Meeting prescribed deadlines for filing transfer pricing documentation with the tax authorities. Having strategies in place to address potential disputes and transfer pricing audits. A clear understanding of cross-border transactions and their potential transfer pricing implications. Identifying transfer pricing risks and implementing measures to mitigate them. Open communication and proactive engagement with tax authorities to resolve any transfer pricing-related queries. Employing professionals with expertise in transfer pricing regulations and methodologies. Aligning transfer pricing practices with international best practices and OECD guidelines. Maintaining transparency in financial and operational aspects to facilitate a smoother transfer pricing process.

16.10 Documentation for transfer pricing:

16.10.1 Master File and Country-by-Country Reporting (CbCR):

The Master File and Country-by-Country Reporting (CbCR) are essential components of transfer pricing documentation. The Master File provides a comprehensive overview of the multinational group's global operations, organizational structure, and transfer pricing policies. It enhances transparency and assists tax authorities in understanding the group's overall transfer pricing arrangements.

On the other hand, CbCR mandates multinational enterprises to report income, taxes paid, and other economic indicators in each country of operation. This ensures transparency on a country-by-country basis, enabling tax authorities to assess if profits are aligned with economic activities in respective jurisdictions. Both tools aim to enhance tax transparency, mitigate base erosion, and facilitate effective tax compliance in the global business landscape.

16.10.2 Advance Pricing Agreements (APAs):

Advance Pricing Agreements (APAs) are pre-established agreements between tax authorities and taxpayers regarding transfer pricing methodologies and pricing principles for specified cross-border transactions. They aim to provide certainty and prevent disputes related to transfer pricing by determining an acceptable arm's length range for these transactions. APAs offer a proactive approach, allowing taxpayers to agree with tax authorities on the appropriate transfer pricing methods and their application for a set period, typically 3 to 5 years. This mechanism enhances transparency, reduces compliance burdens, and encourages investment by providing predictability in tax outcomes. It promotes a cooperative relationship between

taxpayers and tax authorities, fostering an efficient and fair international tax environment while aligning with the OECD guidelines for transfer pricing.

16.10.3 Safe Harbor Rules (SHR):

Harbor rules, also known as safe harbor rules, in transfer pricing refer to predefined acceptable parameters or conditions established by tax authorities for certain types of transactions. Taxpayers can opt to apply these rules to determine their transfer prices, providing a safe harbor from potential transfer pricing adjustments. These rules aim to simplify compliance and reduce disputes by offering a clear and predetermined method for calculating transfer prices, especially for routine transactions.

However, it's important to note that safe harbor rules may not always align perfectly with a company's actual circumstances, potentially resulting in either overpayment or underpayment of taxes. Taxpayers must carefully evaluate whether applying these rules is in their best interest based on their specific transactions and industry.

In summary, harbor rules offer a standardized and simplified approach to transfer pricing, but careful consideration and assessment of their appropriateness for a particular business context are essential.

16.10.4 Documentation Requirements:

In India, maintaining comprehensive documentation for transfer pricing is essential to comply with the law and regulations. The transfer pricing documentation requirements are outlined under Section 92D of the Income Tax Act, 1961, and Rule 10D of the Income Tax Rules, 1962. Here's a summary of the key documentation requirements:

- **Transfer Pricing Documentation Report (Form 3CEB)**: Taxpayers engaged in international or specified domestic transactions with associated enterprises must prepare and submit a Transfer Pricing Audit Report in Form 3CEB, which provides details of the transactions, methodologies used, and other relevant information.

- **Maintaining and Furnishing Documentation**: Taxpayers must maintain contemporaneous and detailed transfer pricing documentation to substantiate the arm's length nature of the transactions. This documentation should be available on or before the due date of filing the income tax return.

- **Transaction Information**: The documentation should include information about the entity, its business, details of related parties, the nature and terms of transactions, and any other information necessary to analyze the transfer pricing.

- **Comparable Data and Methodologies**: Documentation should outline the selection of appropriate comparable transactions or entities, along with the transfer pricing methods used and the rationale for their selection.

- **Functional and Risk Analysis**: Taxpayers must provide a functional and risk analysis that explains the functions performed, assets employed, and risks assumed by the taxpayer and the associated enterprise.

- **Economic Analysis and Benchmarking**: The documentation should include an economic analysis demonstrating compliance with the arm's length principle, including benchmarking data and calculations supporting the transfer prices.

- **Record Retention**: Taxpayers must retain the transfer pricing documentation and information for a specified period (usually up to nine years) from the end of the relevant assessment year.

- **Penalties for Non-Compliance**: Failure to maintain adequate documentation or furnishing inaccurate or incomplete information may lead to penalties under the Income Tax Act.

Adhering to these documentation requirements is crucial for ensuring compliance with transfer pricing regulations and minimizing the risk of disputes with tax authorities. It's advisable for taxpayers to work closely with tax professionals to ensure the accuracy, completeness, and timeliness of their transfer pricing documentation.

16.11Penalty Provisions:

The Income Tax Act of India includes penalty provisions related to transfer pricing to ensure compliance and deter tax evasion or manipulation. Here are the key penalty provisions related to transfer pricing:

1. **Penalty for Underreporting of Income (Section 270A):** If the income determined by the tax authorities as per the transfer pricing regulations exceeds the declared income by a certain percentage, a penalty ranging from 50% to 200% of the tax payable on the underreported income may be imposed.

2. **Penalty for Failure to Keep and Maintain Transfer Pricing Documentation (Section 271AA):** If an entity fails to keep and maintain the prescribed transfer pricing documentation, a penalty of INR 1,00,000 (as of my last update) may be levied.

3. **Penalty for Non-Furnishing of Report in Form 3CEB (Section 271G):** Failure to furnish the Transfer Pricing Audit Report in Form 3CEB by the specified due date may result in a penalty of INR 1,00,000 (as of my last update).
4. **Penalty for Misreporting of Information (Section 270):** Any misreporting or misrepresentation of information related to transactions covered under transfer pricing could lead to penalties based on the amount of tax sought to be evaded.

It's important to note that tax laws and penalties may be subject to change or amendments after my last knowledge update in September 2021. Therefore, for the most current and accurate information regarding penalty provisions related to transfer pricing in the Income Tax Act, it is advisable to refer to the latest amendments or consult a tax professional.

16.12 Dispute Resolution Mechanisms:

In India, there are several dispute resolution mechanisms available for transfer pricing cases, aiming to address conflicts between taxpayers and tax authorities regarding transfer pricing adjustments. Here are the key mechanisms:

- **Advance Pricing Agreements (APAs):** Taxpayers can proactively enter into APAs with the tax authorities to agree on an appropriate transfer pricing methodology for a set period. This helps provide certainty and reduce transfer pricing disputes.

- **Mutual Agreement Procedure (MAP):** The MAP is an avenue for resolving disputes arising from the application of tax treaties. Taxpayers can initiate this process to seek resolution through consultation and negotiation between tax authorities of the relevant countries.

- **Dispute Resolution Panel (DRP):** The DRP is an independent body that reviews transfer pricing adjustments proposed by tax authorities. Taxpayers can approach the DRP to present their case before the final assessment order is passed.

- **Appellate Authorities:** Taxpayers can appeal against transfer pricing adjustments to appellate authorities like the Commissioner (Appeals), Income Tax Appellate Tribunal (ITAT), High Court, and the Supreme Court of India, depending on the level of the dispute and the amount involved.

- **Advance Ruling Authority (ARA):** Taxpayers can seek an advance ruling from the ARA to obtain clarity on transfer pricing matters in specific transactions before they occur, providing a pre-emptive dispute resolution mechanism.

- **Arbitration**: Arbitration is another option for resolving transfer pricing disputes, especially if there is an applicable bilateral or multilateral agreement that includes provisions for arbitration.

These mechanisms aim to provide a structured and efficient way to resolve transfer pricing disputes and ensure fairness and transparency in the taxation of international transactions. It's important for taxpayers to carefully consider their options and work with tax professionals to choose the most appropriate mechanism based on their specific situation.

It's essential to consult the latest and most updated regulations and guidelines from the relevant authorities, such as the Central Board of Direct Taxes (CBDT) and the Income Tax Department, to ensure compliance with the current transfer pricing regulations in India. Tax professionals and businesses engaged in cross-border transactions should regularly monitor updates and changes in the Indian transfer pricing landscape.

16.13 Fixation of minimum transfer pricing:

When considering the minimum transfer price, look at transfer pricing from the point of view of the selling division. The question we ask is: what is the minimum selling price that the selling division would be prepared to sell for? Note that this will not necessarily be the same as the price that the selling division would be happy to sell for, although, as you will see, if it does not have spare capacity, it is the same. The minimum transfer price that should be set if the selling division is to be happy is:

Marginal cost + Opportunity cost.

16.14 How to Find the Minimum Transfer Price?

There are different ways to find the minimum acceptable transfer price. Some companies simply set the minimum as equal to variable costs. Others add variable costs with a calculated opportunity cost. The general economic transfer price rule is that the minimum must be greater than or equal to the marginal cost of the selling division.

In economics and business management, a marginal cost is equal to the total new expense incurred from the creation of one additional unit. For example, suppose a hammer manufacturing company has two divisions: a handle division and a hammer head division. The hammer head division only begins work after receiving handles from the handle division. This means the handle division is the selling division and the hammer head division is the buyer.

If it costs the handle division Rs. 250/- to fashion its next handle (its marginal cost of production) and ship it off, it doesn't make sense for the transfer price to be Rs. 200/- (or any other amount less than Rs. 250/-). Otherwise, the handle division would lose money at the expense of money gained by the hammer head division.

16.14.1 Factoring in Opportunity Costs:

Suppose that the hammer company also sells replacement handles for its products. In this scenario, it sells some handles through retail sales rather than sending them to the hammer head division. Suppose again that the handle division can realize a Rs. 150/- profit margin on its sold handles.

Now the cost of selling a handle isn't just the Rs. 250/- marginal cost of production, but also the Rs. 150/- in lost profit (opportunity cost) from not selling the handle directly to consumers. This means the new minimum transfer price must be Rs. 350/- (Rs. 150 + 200).

16.14.2 Spare capacity:

If there is spare capacity, then, for any sales that are made by using that spare capacity, the opportunity cost is zero. This is because workers and machines are not fully utilised. So, where a selling division has spare capacity the minimum transfer price is effectively just marginal cost. However, this minimum transfer price is probably not going to be one that will make the managers happy as they will want to earn additional profits. So, you would expect them to try and negotiate a higher price that incorporates an element of profit.

16.14.3 No spare capacity:

If the seller doesn’t have any spare capacity, or it does not have enough spare capacity to meet all external demand and internal demand, then the next question to consider is: how can the opportunity cost be calculated? Given that opportunity cost represents contribution foregone, it will be the amount required in order to put the selling division in the same position as they would have been in had they sold outside of the group.

Logically, the buying division must be charged the same price as the external buyer would pay, less any reduction for cost savings that result from supplying internally. These reductions might reflect, for example, packaging and delivery costs that are not incurred if the product is supplied internally to another division.

It is not really necessary to start breaking the transfer price down into marginal cost and opportunity cost in this situation, it can simply be calculated as the external market price less any internal cost savings.

At this transfer price, the selling division would make just as much profit from selling internally as selling externally. Therefore, it reflects the price that they would actually be happy to sell at. They should not expect to make higher profits on internal sales than on external sales.

16.15 Process of fixation of transfer pricing:

Fixing a minimum transfer price refers to establishing a specific price floor or baseline below which transactions between related parties within a multinational enterprise (MNE) should not fall. The purpose of setting a minimum transfer price is to ensure that transactions between related entities comply with arm's length principles and avoid potential tax evasion, profit shifting, or other transfer pricing concerns.

When an MNE has entities operating in different tax jurisdictions, they engage in various intra-group transactions, such as the sale of goods, provision of services, or transfer of intangible assets. These transactions should be conducted at prices similar to those that would be agreed upon by unrelated parties in a comparable situation. The arm's length principle is the key guiding principle for setting transfer prices, aiming to ensure that transactions between related parties are conducted on fair and market-based terms.

By fixing a minimum transfer price, a company establishes a baseline to comply with transfer pricing regulations, which often mandate that transactions between related parties should meet or exceed this minimum price. This helps prevent the shifting of profits to low-tax jurisdictions and helps maintain tax revenues in the countries where the economic activities actually occur.

The process of fixing a minimum transfer price typically involves conducting a thorough transfer pricing analysis, identifying comparable transactions with unrelated parties, selecting an appropriate transfer pricing method, and determining a reasonable minimum price based on this analysis.

It's important to note that transfer pricing rules and regulations vary across jurisdictions, and compliance with the specific laws and guidelines of the relevant tax authorities is essential when setting a minimum transfer price. Working with tax experts and legal advisors is crucial to ensure compliance and avoid any potential legal or financial risks associated with transfer pricing.

16.16 Establishment of minimum transfer price:

Establishing a minimum transfer price involves a systematic procedure to ensure compliance with transfer pricing regulations and the arm's length principle. Here's a step-by-step approach for fixing a minimum transfer price:

- **Understand Applicable Laws and Guidelines:** Familiarize yourself with the transfer pricing laws, regulations, and guidelines relevant to the jurisdictions where the related parties operate. Each jurisdiction may have specific rules and methodologies for determining transfer prices.

- **Identify Controlled Transactions:** Identify the transactions or arrangements that involve the transfer of goods, services, or intangible assets between related parties. These transactions are subject to transfer pricing regulations.

- **Conduct a Functional and Risk Analysis:** Analyze the functions performed, risks assumed, and assets utilized by each related party involved in the transaction. Understand their contributions to the value chain and the economic substance of their roles.

- **Select an Appropriate Transfer Pricing Method:** Choose the most suitable transfer pricing method based on the nature of the transaction, the availability of reliable data, and the industry in which the entities operate. Common methods include the Comparable Uncontrolled Price (CUP) method, Cost Plus method, Resale Price method, Transactional Net Margin Method (TNMM), and others.

- **Identify Comparable Transactions or Entities:** Gather data on comparable transactions or entities (unrelated parties) to use as benchmarks for determining the arm's length range. The comparable should be similar to the controlled transactions in terms of functions, risks, and assets involved.

- **Perform a Comparability Analysis:** Analyze the comparable data to adjust for any differences and ensure comparability with the controlled transactions. Adjustments may be made for factors such as product characteristics, market conditions, contractual terms, and economic circumstances.

- **Determine an Arm's Length Range:** Calculate the arm's length range of prices or profit margins based on the comparability analysis. This range will serve as the basis for setting the minimum transfer price.

- **Establish the Minimum Transfer Price:** Within the arm's length range, set a minimum transfer price that provides a fair and reasonable compensation to the selling entity while ensuring compliance with the applicable transfer pricing regulations.

- **Document the Transfer Pricing Analysis:** Prepare comprehensive documentation that outlines the transfer pricing analysis, the chosen transfer pricing method, the comparable data used, adjustments made, and the rationale for establishing the minimum transfer price.

- **Implement and Monitor Compliance:** Implement the minimum transfer price within the organization and ensure ongoing compliance with the established price. Regularly review and update the transfer pricing policies to align with changing market conditions and regulatory requirements.

- **Consult with Experts:** Seek advice and consultation from transfer pricing experts or professionals experienced in the relevant jurisdiction's transfer pricing regulations to ensure the accuracy and compliance of the established minimum transfer price.

16.17 Minimum Transfer Price and Tax Regulations:

For accounting purposes, large corporations will evaluate their divisions separately for profit and loss. When these different divisions conduct business with one another, the minimum transfer price for a particular good will usually be close to the prevailing market rate for that good. That means that the division selling a good to another division will charge an amount equal to what they could achieve by selling to retail customers.

However, in some instances, companies will attempt to increase or decrease the transfer costs between divisions in order to lower the amount they pay in taxes. This deliberate manipulation of costs is more likely to occur when the divisions are located in different countries where one country is a tax haven and has a much lower tax rate than the other.

Obviously, the tax authorities in countries with higher tax rates frown upon this practice as it means lost revenue for them. Thus, these countries have strict regulations to prevent companies from using transfer pricing as a tax avoidance strategy.

Regulators look at the company's financial statements to ensure their transfer pricing is in line with current market pricing. In general, these regulations attempt to ensure companies abide by arm’s length practices, which prevents collusion between divisions within the company to misstate transfer prices.

16.18 Summary:

Transfer pricing regulations govern transactions between related parties to ensure fair market pricing and prevent profit shifting. The arm's length principle is fundamental, requiring transactions to reflect what independent parties would agree upon. The Income Tax Act prescribes acceptable transfer pricing methods (e.g., Comparable Uncontrolled Price, Cost Plus) and requires contemporaneous documentation supporting pricing methodologies. There are minimum transfer pricing thresholds that trigger compliance obligations—typically applicable to transactions exceeding specific monetary limits. Taxpayers engaged in such transactions must maintain detailed documentation and submit transfer pricing reports to the tax authorities, demonstrating adherence to arm's length pricing. Non-compliance can lead to penalties and adjustments by tax authorities, highlighting the significance of accurate and compliant transfer pricing practices for businesses operating in India.

16.19 Key words:

Global tax planning: What does International Tax Planning mean? International tax planning is the strategic management of cross-border financial operations and structures to minimize tax burdens, eliminate or mitigate double taxation, and optimize tax benefits.

Benchmarking analysis: Benchmarking analysis is a specific type of market research that allows organizations to compare their existing performance against others and adopt improvements that fit their overall approach to continuous improvement and culture.

APAs: An Advance Pricing Agreement (APA) is a procedural agreement between one or more taxpayers and one or more tax authorities that aims to avoid any transfer pricing disputes, by determining in advance a set of criteria to apply, within a specified period of time, for specific cross-border controlled transactions, to ensure their consistence with the market principle.

Attorneys: An attorney is a lawyer. Attorneys sue people, defend people, and serve as experts on the law. When there's any kind of legal issue, attorneys will be involved. They're the legal experts with law degrees who are also known as "lawyers." You'll often find them in court, defending clients or trying to put criminals in jail. Attorneys work for businesses, schools, the government, and individuals. So, if you get arrested, need to write a will, or have to hash out a binding contract, an attorney is the person to call.

Profitability ratios: Profitability ratios are a class of financial metrics that are used to assess a business's ability to generate earnings relative to its revenue, operating costs, balance sheet assets, or shareholders’ equity over time, using data from a specific point in time. They are among the most popular metrics used in financial analysis.

Notoriety: Notoriety is fame you get from doing something bad or being part of a misfortune or scandal. Just remember: Notoriety's not al-righty.

Economic analysis:

Economic analysis essentially entails the evaluation of costs and benefits. It starts by ranking projects based on economic viability to aid better allocation of resources. It aims at analyzing the welfare impact of a project.

Harbor rules: "Safe Harbour" means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee. Thus, 'safe harbour rules' means binding rules laid down under law which obliges income-tax authorities to accept the transfer price declared by the assessee.

16.20 Self – assessment questions:

1. Write a note on various aspects of transfer pricing.
2. What are the basic parameters for sustaining transfer pricing?
3. What are objectives of transfer pricing?
4. What document are required for implementation of transfer pricing?
5. What are the penalties posed on misuse of transfer pricing?
6. What mechanism established for resolution of issues in transfer pricing?

16.21 Further readings:

1. K. Vaitheeswaran - "Transfer Pricing: A Global Perspective" - Taxmann Publications Pvt. Ltd.
2. Rajendra Kumar - "Transfer Pricing - Law and Practice" - Bharat Law House
3. Rohit Jain - "Transfer Pricing: A Complete Analysis" - Bloomsbury Professional India
4. S. R. Kothari - "Transfer Pricing: Methods and Procedures" - Snow White Publications Pvt. Ltd.
5. Sanjiv Malhotra, Nipun Singhvi - "A Complete Guide to Transfer Pricing" - CCH a Wolters Kluwer business
6. James R. Hines Jr., R Glenn Hubbard, Joel Slemrod - "The Economic Analysis of Corporate Taxation" - Cambridge University Press
7. Lorraine Eden, Oliver Oldman - "Transfer Pricing and Corporate Taxation: Problems, Practical Implications, and Proposed Solutions" – Springer
8. Michael Lang, Peter Melz - "Introduction to Transfer Pricing" - Linde Verlag
9. Matthias Petutschnig, Frédéric Sonenscher - "Transfer Pricing: A Swiss Perspective" Schulthess
10. Juristische Medien AG Raymund H. Richter - "Transfer Pricing Handbook" - Wiley

Dr. K. Vanitha

Lesson -17
SEGMENT REPORTING

Learning Objectives

- ✓ To Understand the objective and key aspects of segment reporting
- ✓ To know the scope of segment reporting
- ✓ To learn the components of segment reporting
- ✓ To identify the reportable segments
- ✓ To study the format of segment reporting

Structure

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17.0 Introduction

Transitioning from a private to a public company comes with increased accountability demands, particularly when it comes to financial reporting. One of the requirements for private companies is segmental, or segment reporting. Here's what you need to know. 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. The goal is to increase transparency for creditors and investors, especially regarding the company's most important operating units. This shines a focused light on performance, helping investors make better decisions and predict future prospects for cash flow.

Generally accepted accounting principles (GAAP) refer to a common set of accounting rules, standards, and procedures issued by the Financial Accounting Standard Board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements.

GAAP is guided by ten key tenets and is a rules-based set of standards. It is often compared with the International Accounting Financial Reporting Standard (IFRS), which is considered more of a principles-based standard. IFRS is a more international standard, and there have been recent efforts to transition GAAP reporting to IFRS.

GAAP helps govern the world of accounting according to general rules and guidelines. It attempts to standardize and revenue recognition balance sheet classification, and materiality. The ultimate goal of GAAP is to ensure a company's financial statement are complete, consistent, and comparable. This makes it easier for investors to analyze and extract useful information from the company's financial statements, including trend data over a period of time. It also facilitates the comparison of financial information across different companies.

Accounting standards have now become the life blood of any business enterprise and its financial statement. As per section 211(3A) of the Companies Act, 1956, every balance sheet and profit and loss account of the company shall comply with accounting standards. Even clause 49 of the listing agreement of stock exchanges makes it obligatory for the listed companies to comply with the accounting standards applicable in India.

One such standard is a relatively new accounting standard on "Segment Reporting" issued by the Institute of Chartered Accountants of India (ICAI). Known as Accounting Standard-17 (AS-17), it deals with accounting, presentation and disclosure in financial statements of reportable segments of an enterprise which could be a business segment (i.e., a product, a division, a unit, a process or a class of products or services or a business classified as a distinguishable business segment) or a geographic segment based upon geographic boundaries, locations, nature of risks associated with businesses, regulations, operations in different locations etc. (e.g., exports, imports, domestic, international, regional segmentation, etc.).

The Institute of Chartered Accountants of India has issued AS-17 on "Segment Reporting" (corresponding international accounting standard being IAS-14) effective from 1-4-2001. The standard is mandatory for enterprises whose equity or debt securities are listed on a recognized stock exchange in India and for enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchanging in India. It is also mandatory for enterprises having a turnover of over Rs.50 crore in an accounting period. For other entities, it is recommendatory.

17.1 Concept of segment reporting

Business segment reporting breaks out a company's financial data by company divisions, subsidiaries or other kinds of business segments. In an annual report, business segment reporting provides an accurate picture of public companies' performance to its shareholders. Management uses business segment reporting to evaluate the income, expenses, assets, and liabilities of each business division to assess its general health including profitability and potential pitfalls.

A segment is a component of a business that generates its own revenues and creates its own product, product lines, or service offerings. In general, if a unit of a business can be lifted

out of the larger company and remain a self-sufficient entity, then it may be classified as a business segment.

17.2 Definition:

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. 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. 5.4 Enterprise revenue is revenue from sales to external customers as reported in the statement of profit and loss. 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.

However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis. 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, 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.

The factors identifying business segments and geographical segments are not listed in any particular order. A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services

included in a single business segment are expected to be similar with respect to a majority of the factors. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country. 9. The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:

(a) the location of production or service facilities and other assets of an enterprise; or
(b) the location of its customers.

The organizational and internal reporting structure of an enterprise will normally provide evidence of whether its dominant source of geographical risks results from the location of its assets (the origin of its sales) or the location of its customers (the destination of its sales). Accordingly, an enterprise looks to this structure to determine whether its geographical segments should be based on the location of its assets or on the location of its customers. Determining the composition of a business or geographical segment involves a certain amount of judgement. In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in this Standard and the qualitative characteristics of financial statements as identified in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. The qualitative characteristics include the relevance, reliability, and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise as a whole. The predominant sources of risks affect how most enterprises are organized and managed. Therefore, the organizational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

The definitions of segment revenue, segment expense, segment assets and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis. An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Such an allocation would not constitute a reasonable basis under the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Standard.

Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for

doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Standard.

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. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment. 18. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

17.3 Objectives

The objective of this standard is to establish principles for reporting financial information by segment, i.e., information about the different types of products and services an enterprise produces and the different geographical areas in which it operates. It shall be applied to annual general purpose financial statements that are prepared and published in accordance with the relevant statute. Such information helps users of financial statements:

(a) better understand the performance of the enterprise;
(b) better assess the risks and returns of the enterprise; and
(c) make more informed judgements about the enterprise as a whole.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas - often called segment information is relevant to

assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

17.4 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.

17.5 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.

Accounting standards have now become the life blood of any business enterprise and its financial statement. As per section 211(3A) of the Companies Act, 1956, every balance sheet and profit and loss account of the company shall comply with accounting standards. Even clause 49 of the listing agreement of stock exchanges makes it obligatory for the listed companies to comply with the accounting standards applicable in India.

One such standard is a relatively new accounting standard on "Segment Reporting" issued by the Institute of Chartered Accountants of India (ICAI). Known as Accounting Standard-17 (AS-17), it deals with accounting, presentation and disclosure in financial statements of reportable segments of an enterprise which could be a business segment (i.e., a product, a division, a unit, a process or a class of products or services or a business classified as a

distinguishable business segment) or a geographic segment based upon geographic boundaries, locations, nature of risks associated with businesses, regulations, operations in different locations etc. (e.g., exports, imports, domestic, international, regional segmentation, etc.).

17.6 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.

17.7 Geographical Segment

Business segment is a distinguishable unit of an enterprise engaged in providing products or services within a particular economic environment. Further, it is subject to risk and returns that are different from units operating in other economic environments.

17.8 Reportable Segment:

It is a business or geographical segment for which segment information is required to be disclosed. In order to determine whether enterprise will consider business segments or geographical segments as the primary segment reporting format, the dominant source and nature of risks and returns of an enterprise are considered. The primary format for reporting segment information should be business segments if the risks and returns of an enterprise are majorly impacted by variations in the products and services it produces

The primary format for reporting segment information should be geographical segments if the risks and returns of an enterprise are majorly impacted by the geographical areas in which it operates. To identify the predominant source and risk and return of an enterprise, internal organization and management structure of an enterprise, as well as the system of the internal financial reporting to the top management, is generally considered. There can be two possibilities:

1. The enterprise can consider business segments as its primary segment reporting format and geographic segments as its secondary format. This is the case when risk and returns of an enterprise get majorly affected both by differences in products and services it produces and by differences in geographical areas in which it operates.
2. The enterprise can choose business segments or geographic segments as its as primary segment reporting format with the other as its secondary reporting format using its judgement. This is the case where the internal organization and management structure of an enterprise and its system of internal financial reporting to the top management are neither based on individual products or services nor on geographical areas. In case the segments reported internally to the top management do not comply with the definition of the business and geographical segment as mentioned above, in such case management must consider next lower level of internal segmentation that reports information along product or service lines or geographical lines.

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

17.9 Difference between business, Geographical, and reportable segments

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

17.10 Interna segment reporting

Internal organization and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided in sub-paragraphs (a) and (b) below:

(a) if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach' to managing the company and to reporting internally to the board of directors and the chief executive officer, then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and

(b) if internal organizational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/ services nor on geographical areas, the directors and management of the enterprise should determine whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and should, accordingly, choose business segments or geographical segments as the primary segment reporting format of the enterprise, with the other as its secondary reporting format.

For most enterprises, the predominant source of risks and returns determines how the enterprise is organized and managed. Organizational and management structure of an enterprise and its internal financial reporting system normally provide the best evidence of the predominant source of risks and returns of the enterprise for the purpose of its segment reporting. Therefore, except in rare circumstances, an enterprise will report segment information in its financial statements on the same basis as it reports internally to top management. Its predominant source

of risks and returns becomes its primary segment reporting format. Its secondary source of risks and returns becomes its secondary segment reporting format.

A 'matrix presentation' - both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Standard does not require, but does not prohibit, a 'matrix presentation'. In some cases, organization and internal reporting of an enterprise may have developed along lines unrelated to both the types of products and services it produces, and the geographical areas in which it operates. In such cases, the internally reported segment data will not meet the objective of this Standard. Accordingly requires the directors and management of the enterprise to determine whether the risks and returns of the enterprise are more product/service driven or geographically driven and to accordingly choose business segments or geographical segments as the primary basis of segment reporting. The objective is to achieve a reasonable degree of comparability with other enterprises, enhance understandability of the resulting information, and meet the needs of investors, creditors, and others for information about product/service-related and geographically related risks and returns.

17.11 External segment Reporting

Business and geographical segments of an enterprise for external reporting purposes should be those organizational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the unit's performance and for making decisions about future allocations of resources. If internal organizational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas requires that the directors and management of the enterprise should choose either business segments or geographical segments as the primary segment reporting format of the enterprise based on their assessment of which reflects the primary source of the risks and returns of the enterprise, with the other as its secondary reporting format.

In that case, the directors and management of the enterprise should determine its business segments and geographical segments for external reporting purposes based on the factors of this Standard, rather than on the basis of its system of internal financial reporting to the board of directors and chief executive officer,

a. if one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors but others are not, should be applied only to those internal segments that do not meet the (that is, an internally reported segment that meets the definition should not be further segmented);

b. for those segments reported internally to the directors and management that do not satisfy the management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines;

c. if such an internally reported lower-level segment meets the definition of business segment or geographical segment based on the factors for identifying reportable segments should be applied to that segment.

Most enterprises will identify their business and geographical segments as the organizational units for which information is reported to the board of the directors (particularly the non-executive directors, if any) and to the chief executive officer (the senior operating decision maker, which in some cases may be a group of several people) for the purpose of evaluating each unit's performance and for making decisions about future allocations of resources. Even if an enterprise must apply because its internal segments are not along product/service or geographical lines, it will consider the next lower level of internal segmentation that reports information along product and service lines or geographical lines rather than construct segments solely for external reporting purposes. This approach of looking to organizational and management structure of enterprise and its internal financial reporting system to identify the business and geographical segments of the enterprise for external reporting purposes is sometimes called the 'management approach', and the organizational components for which information is reported internally are sometimes called 'operating segments'. A business segment or geographical segment should be identified as a reportable segment if:

(a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or
(b) its segment result, whether profit or loss, is 10 per cent or more of –

(i) the combined result of all segments in profit, or
(ii) the combined result of all segments in loss, whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments. 28. A business segment or a geographical segment which is not a reportable segment may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds in paragraph 27, until at least 75 per cent 30. The 10 per cent thresholds in this Standard are not intended to be a guide for determining materiality for any aspect of financial reporting other than identifying reportable business and geographical segments.

A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 per cent thresholds. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to

reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

17.12 Segment Accounting Policies

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. There is a presumption that the accounting policies that the directors and management of an enterprise have chosen to use in preparing the financial statements of the enterprise as a whole are those that the directors and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements better understand and make more informed judgements about the enterprise as a whole, this Standard requires the use, in preparing segment information, of the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. That does not mean, however, that the enterprise accounting policies are to be applied to reportable segments as if the segments were separate stand-alone reporting entities. A detailed calculation done in applying a particular accounting policy at the enterprise-wide level may be allocated to segments if there is a reasonable basis for doing so.

Pension calculations, for example, often are done for an enterprise as a whole, but the enterprise-wide figures may be allocated to segments based on salary and demographic data for the segments. This Standard does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. The way in which asset, liability, revenue, and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all enterprises; nor is it appropriate to force allocation of enterprise asset, liability, revenue, and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary. At the same time, the definitions of segment revenue, segment expense, segment assets, and segment liabilities are interrelated, and the resulting allocations should be consistent. Therefore, jointly used assets and liabilities are allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. For example, an asset is included in segment assets if, and only if, the related depreciation or amortization is included in segment expense.

Segment information must be prepared as per the accounting policies adopted for preparing and presenting the enterprise's financial statements. Furthermore, assets and liabilities that jointly relate to two or more segments should be allocated to the respective statements. Provided their related revenues and expenses are allocated to such segments.

17.13 Primary Reporting Format:

Following are the items that an enterprise must disclose for each reportable segment:

- Segment revenue
- Segment result
- Total carrying amount of segment assets
- Total amount of segment liabilities
- Cost incurred in a given period to acquire segment assets expected to be used during more than one period.

Expense included in segment result for depreciation and amortization pertaining to the segment assets for the period:

- Significant non – cash expenses other than depreciation and amortization in respect of segment assets that were included in segment expense and thus deducted while measuring segment result

- Furthermore, an enterprise need not disclose depreciation and amortization expense as well as non-cash expenses of a segment if it reports the amount of cash flows arising from operating, investing and financing activities of such a segment.

- In addition to this, the enterprise should also present reconciliation between information disclosed for reportable segments and aggregated information in the enterprise financial statements.

17.14 Primary Segment Reporting Format in Business Segments:

If the primary format of segment reporting is business segments, following information should also be reported:

- segment revenue from external customers by geographical area based on the geographical location of its customers. Provided the revenue from sales to external customers for each geographical segment is 10% or more of enterprise revenue.

- total carrying amount of segment assets by geographical location of assets provided the segment assets for each geographical segment are 10% or more of the total assets of all geographical segments.

- total cost incurred during the period to acquire segment assets expected to be used for more than one period by geographical location of assets. Provided segment assets for each geographical segment are 10% or more of total assets of all geographical assets

17.15 Primary Segment Reporting Format in Geographical Segments:

There are cases where primary format of segment reporting is geographical segments (whether based on location of assets or location of customers). In such a case, the enterprise should also report following segment information for each business segment having revenue from sale to external customers equal to 10% or more of enterprise revenue or having segment assets equal to 10% or more of total assets of all business segments:

Segment revenue from external customers total carrying amount of segment assets total cost incurred during the period to acquire segment assets expected to be used during more than one period. There is another case where the primary format of segment reporting is geographical

segments based on location of assets. And the location of customers is different from the location of its assets. In such a case, enterprise should also record revenue for sale to external customers for each customer based geographical segment. Provided that revenue from sales to external customers is 10% or more of enterprise revenue.

There is another case where the primary format of segment reporting is geographical segments based on location of customers. And the assets of the enterprise are located in different geographical areas from its customers. In such a case enterprise should also report the following segment information for each asset based geographical segment provided revenue from sales to external customers or segment assets are 10% or more of total enterprise amounts:

Total carrying amount of segment assets by geographical location of assets total cost incurred during the period to acquire segment assets expected to be used for more than one period by location of the assets

17.16 Summary

Investors, lenders, creditors, and other allocators of capital (collectively “investors”) have observed that segment information is critically important in understanding a public entity’s different business activities. That information enables investors to better understand an entity’s overall performance and assists in assessing potential future cash flows. Disclosures about Segments of an Enterprise and Related Information, indicated overall support from stakeholders for the management approach to segment reporting. That report stated that investors are generally satisfied with the segment note disclosures.

17.17 Key words:

Segment Reporting: Transitioning from a private to a public company comes with increased accountability demands, particularly when it comes to financial reporting. One of the requirements for private companies is segmental, or segment reporting. Here’s what you need to know.

Financial Accounting Standard Board (FASB): The Financial Accounting Standard Board sets the accounting standards for business segment reporting. FASB Accounting Standards Codification (ASC) 280-10-10-1 requires that all segments of a company's business align with the company's reporting structure. A company does not need to report all of its business segments, however. According to U.S.

Generally Accepted Account Principles (GAAP): Generally accepted accounting principles (GAAP) refer to a common set of accounting rules, standards, and procedures issued by the Financial Accounting Standard Board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements.

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.

Geographical Segment: Business segment is a distinguishable unit of an enterprise engaged in providing products or services within a particular economic environment. Further, it is subject to risk and returns that are different from units operating in other economic environments.

17.18 Self-Assessment Questions

1. What is meant by segment reporting?
2. What is the objective and scope of segment reporting?
3. What is a segment reporting in AS17?
4. What is difference between internal and external segment reporting?

17.19 Suggested Reading

1. Segment Reporting under IFRS 8: Reporting practice and economic consequences: 13 (Muenster aner Schriften Zur Internationalen Unternehmensrechnung) Hardcover – Import, 24 August 2015 by Marin Nienhaus (Author)
2. Amazon.in - Buy Global Financial Accounting and Reporting: Principles and Analysis book online at best prices in India on Amazon.in. Read Global …
3. Corporate Segment Reporting: Theory and Practice Hardcover – 1 January 2016 by Seema Srivastava (Author)
4. Segment Reporting practices in India: A case study of TCS Ltd Paperback by Bhagavan Das (Author, Contributor)
5. Disclosure Criteria and Segment Reporting (Univ Off Accounting Series No. 10) Paperback Import, 1 March 1989 by Rassel M. Barefield. (Editor), Gary L. Holst rum Editor)
6. Practical Guide to Ind-AS & IFRS – Latest ***8th Edition 2023*** by CA Kamal Garg –Bharat
7. Segment reporting: theoretical analysis and empirical approach in Greek enterprises Charalambos. T. Spathis Pages 804-807 | Published online: 07 Dec 2010 Cite this article https://doi.org/10.1080/09638189700000021.

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Lesson-18

DISCLOSURE REQUIREMENTS

Learning objectives

- ✓ To understand the importance of Disclosure Requirement
- ✓ To know the objectives and key aspects of Disclosure Requirements
- ✓ To learn the concept of Disclosure Requirements
- ✓ To identify the components and information of Disclosure Requirements
- ✓ To find the Disclosure Practices in India

Structure

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18.0 Introduction

Problems of corporate financial disclosure and its governmental regulation are widely and vigorously discussed in the United States as well as in European countries, yet the focus of the debates seems to move in different directions. U.S. economists and, more recently, legal commentators have increasingly challenged the theoretical foundation of the U.S. securities act's disclosure scheme. Their broadened attack even may have had its impact on the regulatory process itself. This widespread academic criticism has, on the whole, no equal in the European discourse. Regulators in Europe, stimulated partly by the EEC's efforts to harmonize the corporate laws of its members still tend to tighten up their rules on corporate information. As far as their regulatory objectives are concerned, financial disclosure requirements in the U.S. and European countries differ in remarkable ways. The most significant difference results from the broader range of public policy goals underlying the

European acts. While the U.S. disclosure acts have addressed the needs of investors and capital markets exclusively, European rules often reveal a concern for other corporate constituencies, in particular, creditors and employees, and for the general public. The discrepancies between various disclosure laws, however, decrease gradually when analysed within a narrower shareholder and market-oriented perspective. U.S. and European regulators alike have considered fairness and corporate governance related aspects, with the intention of enhancing the efficiency of their national securities markets.

This Guidance was developed as part of the IASB's project Disclosure Initiative Targeted Standards-level Review of Disclosures. The Guidance provides the IASB with a framework for developing and drafting disclosure requirements in IFRS Accounting Standards. The rationale of the Guidance is that such disclosure requirements, when applied by an entity, provide users of financial statements with useful information at a cost that does not exceed the benefits of its provision. The IASB might need to adapt its application of this Guidance to the specific circumstances of the individual projects. For example, it might be difficult for the IASB to apply the Guidance in full when amending the disclosure requirements in an Accounting Standard issued before the Guidance was developed. Although this Guidance is based on the requirements in the Due Process Handbook, it does not form part of the IASB's due process. The IASB will use its experience of developing and drafting disclosure requirements across different projects, and its understanding of the effects of applying those disclosure requirements, to update the Guidance as and when required.

18.1 Objectives of Disclosure Requirements

Considering the objective of the financial statements and the views of Board members on an earlier draft disclosure objective we think the disclosure objectives and disclosure requirements need to focus on the effects that the transactions or other events that give rise to regulatory timing differences have on the entity's financial performance and financial position. Such information will help users to better understand the entity's financial performance trend and help users to assess management's stewardship and the entity's prospects for future net cash inflows from its rate-regulated activities. The financial information provided by the model will supplement the information that other Standards already require about other aspects of the entity's financial performance trend and the entity's prospects for future cash flow generation.

18.2 Specific disclosure requirement information.

To enable entities to make effective materiality judgments, the IASB, when drafting disclosure requirements, will typically:

(a) include an overall disclosure objective that provides context of the overall user information needs to enable an entity to make materiality judgments and apply the requirements about specific disclosure objectives and items of information;

(b) require an entity to comply with specific disclosure objectives;

(c) support each specific disclosure objective with explanations of user assessments that rely on information an entity would disclose in satisfying the specific disclosure objective; and

(d) link a specific disclosure objective with items of information that an entity is required to disclose to satisfy that specific disclosure objective.

18.3 Overall disclosure requirement objective

The IASB uses an overall disclosure objective in an Accounting Standard to provide an Accounting Standard specific context of the overall user information needs to enable an

entity to make materiality judgments and apply the requirements about specific disclosure objectives and items of information. IAS 1 Presentation of Financial Statements says that an entity: (a) need not provide a specified disclosure required by an Accounting Standard if the information resulting from that disclosure is not material; and (b) should also consider if additional disclosures are necessary if compliance with the specified requirements in an Accounting Standard is insufficient to enable users of financial statements to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. The overall disclosure objective prompts an entity to consider whether applying the requirements about the specific disclosure objectives and items of information would result in disclosing material information to enable users of financial statements to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. The IASB will ensure that the focus of an overall disclosure objective is closely aligned with the objective of financial statements and the purpose of disclosure requirements.

18.4 Concept of Disclosure Requirement

The disclosures required for reportable segments for primary segment reporting format of an enterprise. Identify the disclosures required for secondary reporting format of an enterprise. Enterprises are encouraged to make all of the primary-segment disclosures identified for each reportable secondary segment although require considerably less disclosure on the secondary basis address several other segment disclosure matters. In case, by applying the definitions of 'business segment' and 'geographical segment', it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information as per this Standard is not required to be disclosed. However, the fact that there is only one 'business segment' and 'geographical segment' is disclosed by way of a note.

According to AS-17, segment reporting should cover 75% or more of the total revenue of the enterprise. The segments could be business segment or geographic segments. The information can also be presented in a matrix form. Following disclosures should be made by reporting enterprise:

- An enterprise should disclose segment revenue for each reportable segment. Segment revenue from sales to external customers and segment revenue from transaction with other segments should be separately reported.
- An enterprise should disclose segment result for each reportable segment and segment liabilities for each reportable segment. It should also disclose the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (fixed assets, and intangible assets) for each reportable segment.
- An enterprise should disclose in the segment result the total amount of depreciation and amortization in respect of segment assets for the period for each reportable segment.
- For the purpose of reporting segment revenue from transactions with other segments, inter-segment transfers should be priced. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.
- Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change, if it is reasonably determinable.

- An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, if not otherwise disclosed in the financial statements or elsewhere in the financial report.

Disclosure of segment information is required in a complete set of financial statement of an investment accounted for by the cost or equity method when such statement is presented in the financial report of another enterprise. All of the percentage tests required by FAS-14, however, are computed by excluding the amounts attributable to the investment accounted for the cost or equity method. For example, the 10% revenue test to determine a reportable segment under FAS-14 must be computed on the total of the enterprise's industry segments. When determining the same test for an investment accounted for by the cost or equity method, all revenue from such an investment is eluded and the 10% is computed only on the other industry segments of the primary reporting entity. All other percentage test required by FAS-14 are determined in the same manner (that is, by excluding the amounts attributable to the investment accounted for by the cost or equated method.)

18.5 Purpose of disclosure requirements:

The Conceptual Framework for Financial Reporting (Conceptual Framework) says that the objective of financial statements is to provide financial information about a reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources. That financial information is provided:

(a) in the statement of financial position, by recognizing assets, liabilities and equity;
(b) in the statement(s) of financial performance, by recognizing income and expenses;
(c) in other statements and notes, by presenting and disclosing information about:

(i) recognized assets, liabilities, equity, income and expenses, including information about their nature and about the risks arising from those recognized assets and liabilities;
(ii) unrecognized assets and liabilities, including information about their nature and about the risks arising from them;
(iii) cash flows;
(iv) contributions from holders of equity claims and distributions to them; and
(v) the methods, assumptions and judgments used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgement.

18.6 Information about disclosure requirement

The IASB identifies items of information and uses the prescriptive language 'shall' to require an entity to disclose those items of information to satisfy a specific disclosure objective. In deciding whether to require disclosure of an item of information, the IASB will consider whether such information is likely to be useful to users of financial statements that is whether the information is relevant and faithfully represents what it purports to represent. The IASB explicitly links every item of information described in the disclosure section of an Accounting Standard to one or more specific disclosure objectives. Such links clarify the relationship between a specific disclosure objective and the items of information to be disclosed; and, therefore, they help an entity make effective materiality judgments about the information that it needs to disclose in order to satisfy the detailed information needs of users

(as explained in the specific disclosure objective). The items of information the IASB requires an entity to disclose are those typically required to satisfy the linked specific disclosure objective. The application of materiality could lead an entity to disclose one, some or all items of information specified in an Accounting Standard, or to disclose additional items of information not specified in the Accounting Standard if those additional items are required to satisfy the specific disclosure objective. The IASB decides, on a case-by-case basis, the number of items of information to be linked to a specific disclosure objective. As explained in paragraph 15, the IASB could decide it is unnecessary to complement a specific disclosure objective with items of information if, for example, the purpose of the specific disclosure objective was to make an entity disclose entity-specific information.

18.7 Disclosure in the financial statements include information

Disclosures in the financial statements also include information about:

(a) transactions and other events that have occurred after the end of the reporting period if providing that information is necessary to meet the objective of financial statements; and

(b) possible future transactions and other possible future events (forward-looking information). If that information:

(i) is useful to users of financial statements; and

(ii) relates to an entity's assets or liabilities including unrecognized assets or liabilities or equity that existed during or at the end of the reporting period, or to income or expenses for the reporting period.

As part of the Primary Financial Statements project, the IASB is developing descriptions of the roles of the primary financial statements and the notes. Primary financial statements statement(s) of financial performance, statement of financial position, statement of changes in equity and statement of cash flows provide a structured summary of a reporting entity's recognized assets, liabilities, equity, income, expenses and cash flows.

(a) to obtain an understandable overview of the entity's assets, liabilities, equity, income, expenses and cash flows;

(b) to make comparisons between entities, and between reporting periods for the same entity; and

(c) to identify items or areas about which users of financial statements may wish to seek additional information in the notes.

18.8 Types of disclosure financial statements information

Therefore, given the objective of financial statements and the different roles of the primary financial statements and the notes the purpose of the disclosure requirements in an Accounting Standard can be stated as to require an entity to disclose the following types of information in the notes, if such information is useful to users of financial statements:

(a) information that supplements the information presented in the primary financial statements, including:

(i) disaggregation of information presented in the primary financial statements;

ii) information about the nature of, and the risks arising from, recognised assets and liabilities;

(b) information about unrecognised assets and liabilities, including information about their nature and about the risks arising from them:

(c) the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements;

(d) information about transactions and other events that have occurred after the end of the reporting period; and
(e) forward-looking information relating to the entity's assets or liabilities including unrecognised assets or liabilities or equity that existed during or at the end of the reporting period, or to income or expenses for the reporting period.

18.9 Disclosure requirement specific information.

To enable entities to make effective materiality judgments, the IASB, when drafting disclosure requirements, will typically:

(a) include an overall disclosure objective that provides context of the overall user information needs to enable an entity to make materiality judgments and apply the requirements about specific disclosure objectives and items of information;
(b) require an entity to comply with specific disclosure objectives;
(c) support each specific disclosure objective with explanations of user assessments that rely on information an entity would disclose in satisfying the specific disclosure objective; and
(d) link a specific disclosure objective with items of information that an entity is required to disclose to satisfy that specific disclosure objective.

18.10 Materiality Judgments of disclosure requirement:

Similarly, it is unnecessary for each Accounting Standard to explicitly refer to the need to make materiality judgments when applying disclosure requirements because:

(a) materiality is an overarching concept that applies across all Accounting Standards and across all requirements, including disclosure requirements;
(b) the inclusion of references to materiality in new Accounting Standards might create confusion about how this concept applies to Accounting Standards that have not been amended to include those references;
(c) entities might ignore such references, regarding them as mere boilerplate text; and
(d) if an Accounting Standard were to include well-drafted disclosure objectives and clearly linked items of information that satisfy those objectives, then entities, auditors and regulators would be able to understand what information users of financial statements need.

In those circumstances, an entity would only be able to satisfy the disclosure objectives by making effective materiality judgments in relation to its disclosures. Auditors and regulators could then question those judgments.

18.11 Components of the disclosure requirements in an Accounting

The disclosure requirements of an Accounting Standard that have been drafted in accordance with this Guidance will typically comprise three main components:

(a) an overall disclosure objective that describes the overall information needs of users of financial statements;
(b) specific disclosure objectives that describe the detailed information needs of users; and
(c) a description of the items of information that satisfy the specific disclosure objectives.

18.12 Other Disclosure requirements:

In measuring and reporting segment revenue from transactions with other segments, inter segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Changes in accounting policies adopted for

segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable. AS 5 requires that changes in accounting policies adopted by the enterprise should be made only if required by statute, or for compliance with an accounting standard, or if it is considered that the change would result in a more appropriate presentation of events or transactions in the financial statements of the enterprise. Changes in accounting policies adopted at the enterprise level that affect segment information are dealt with in accordance with AS 5. AS 5 requires that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted. Some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effect of the change, if reasonably determinable. An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements. To assess the impact of such matters as shifts in demand, changes in the prices of inputs or other factors of production, and the development of alternative products and processes on a business segment, it is necessary to know the activities encompassed by that segment. Similarly, to assess the impact of changes in the economic and political environment on the risks and returns of a geographical segment, it is important to know the composition of that geographical segment.

18.13 Understanding the information needs of users of financial statements:

During the research phase of a project, through its outreach meetings with users of financial statements and its consultation documents such as a request for information, research paper or discussion paper, the IASB typically seeks:

(a) to understand whether the information that users of financial statements already receive is sufficient;

(b) if the information is insufficient, to understand whether:

- (i) the recognition and measurement models do not support the information needs of users:
- (ii) the existing disclosure requirements are inadequate, or are not being applied as intended; and

(c) to stimulate discussion about possible approaches to filling any information gaps identified. 36 In developing a discussion paper or an exposure draft, the IASB typically seeks:

- (a) to identify and understand, and then to clearly explain the information needs of primary users of financial statements;
- (b) to gather initial feedback on the potential costs and benefits of disclosing information that satisfies those needs; and

(c) to develop proposals that effectively respond to the information needs of users and feedback on the cost of disclosing the information.

The IASB gets feedback from users through their comment letters on consultation documents. The IASB also seeks input from the international community of users by engaging with, for example:

(a) its consultative body, the Capital Markets Advisory Committee;
(b) user-consultative bodies of national standard-setters;
(c) user-representative groups around the world; and
(d) rating agencies, buy-side and sell-side analysts, portfolio managers and other investment professionals.

In all its outreach activities with users or through its consultation documents, the IASB typically seeks to understand:

(a) what information users of financial statements want an entity to disclose in the notes;
(b) why they are interested in that information;
(c) what assessments they make, or would make, using the information;
(d) what level of detail is required to meet their needs; and
(e) of the items of information they want, what information is central to the making of their assessments.

39 The IASB seeks to obtain sufficient feedback from its outreach activities to be able to develop and clearly explain specific disclosure objectives and the user assessments that rely on information an entity would disclose in satisfying the specific disclosure objectives.

18.14 Understanding the information needs of users of stakeholders

Discussing user information needs with prepares and other stakeholders the IASB seeks to understand from prepares and other stakeholders such as auditors, regulators, national standard-setters and accountancy bodies the potential costs, benefits and effects of disclosure requirements or disclosure proposals. To obtain input from those stakeholders, the IASB engages with, for example:

(a) its consultative groups, including the Global Prepares Forum and project-specific consultative groups;
(b) prepares and prepare representative groups around the world;
(c) the Accounting Standards Advisory Forum, the Emerging Economies Group, national standard-setters, standard-setting bodies and accountancy bodies;
(d) accounting firms; and
(e) regulators and enforcement bodies.

In these outreach activities, or through its consultation documents, the IASB typically seeks to understand:

(a) whether and why applying a disclosure requirement or a disclosure proposal is, or would be, unduly onerous;
(b) whether the information needs addressed by a proposed requirement could be satisfied by requiring the disclosure of alternative items of information that would be less costly to prepare;
(c) what information entities typically disclose in the notes beyond that explicitly required by Accounting Standards and, if so, why they do so;
(d) whether a disclosure requirement or a disclosure proposal is worded in a way that makes it possible, or would make it possible, for preparers, auditors, regulators

and enforcement bodies to assess whether information disclosed, or that would be disclosed, is sufficient, or would be sufficient, to satisfy the disclosure objectives; and

(e) what jurisdictional disclosure requirements that are not required by Accounting Standards are considered useful.

18.15 Developing disclosure requirements

Understanding the information needs of users of financial statements informs both the development of disclosure requirements in an IFRS Accounting Standard and the Accounting Standard's recognition and measurement requirements. The IASB works closely with users of financial statements and other stakeholders early in the standard-setting process to understand what information users want financial statements to contain, and what assessments they would do using that information. Gaining a good understanding of the information needs of users helps the IASB develop sufficiently specific disclosure objectives, clear explanations of the assessments that users make, and descriptions of the items of information that are required to be disclosed. In developing disclosure proposals, the IASB is guided by the Conceptual Framework. User information needs are converted into disclosure proposals to the extent that those information needs are within the remit of the objective of financial statements (see section Purpose of disclosure requirements). The Conceptual Framework says general purpose financial reports, such as financial statements, do not and cannot provide all of the information that primary users need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks. The IASB integrates the development of disclosure requirements with the development of recognition and measurement requirements. The IASB applies a consistent approach to developing disclosure requirements, particularly specific disclosure objectives and items of information. The approach involves:

(a) understanding the information needs of users of financial statements;
(b) discussing user information needs with preparers and other stakeholders;
(c) understanding the disclosures that are required to support recognition and measurement requirements;
(d) performing a cost–benefit analysis;
(e) understanding and documenting the effects of disclosure proposals and requirements; and
(f) considering the digital reporting implications when developing disclosure requirements.

18.16 Disclosures that are required to support recognition and measurement requirements

As well as considering user information needs when developing disclosure requirements, the IASB also considers disclosures that may be required to support recognition and measurement requirements. As it develops the recognition and measurement requirements, the IASB identifies:

(a) disclosure requirements that are required for users to understand the information resulting from applying the recognition and measurement requirements; and
(b) disclosures that provide useful information to users that cannot be provided through the recognition, measurement and presentation requirements in an Accounting Standard. In many cases, feedback from stakeholders informs the IASB's discussions about disclosures that may be required to support recognition and measurement requirements.

18.17 Documenting the effects of disclosure proposals and requirements:

The IASB draws on the knowledge it has acquired throughout the standard-setting process when preparing an effects analysis for inclusion in consultation documents and Accounting Standards. The purpose of this step is to communicate to stakeholders the IASB's expectations about:

(a) the benefits of the disclosure proposals or requirements, including the benefits of improved information for users;

(b) the likely effects and costs of disclosure proposals or requirements for entities, users and other stakeholders; and

(c) any other effects, such as the expected digital reporting or regulatory consequences of disclosure proposals or requirements.

Work performed earlier in a project often provides most of the information necessary for the IASB to document its effects analysis. However, the IASB considers whether further consultation with stakeholders is required to ensure it has a comprehensive understanding of the likely effects of disclosure proposals or requirements.

18.18 Digital reporting implications when developing disclosure requirements:

The IFRS Accounting Taxonomy is a system for classifying and structuring financial data in a manner which:

(a) allows tagging to make that data computer-readable; and

(b) helps users find, understand and compare large amounts of financial information to facilitate efficient financial analysis.

The IFRS Accounting Taxonomy:

(a) lists the computer codes (elements) that preparers can use to identify (tag) disclosures in financial statements prepared using IFRS Accounting Standards;

(b) describes the accounting meaning of each element and provides references to the Accounting Standards; and

(c) organises elements into groups and defines relationships between them, to help preparers and users of tagged financial statements find those elements more easily.

The IASB seeks to develop disclosure requirements that are worded in a manner that facilitates the digital consumption of the information that entities provide by applying those disclosure requirements. In developing disclosure requirements that can be applied effectively in both a digital reporting format and a paper-based format, the IASB seeks to understand whether:

(a) proposed disclosure requirements can be incorporated into the IFRS Accounting Taxonomy and taxonomy elements can be easily created from the wording in disclosure proposals;

(b) developing the IFRS Accounting Taxonomy highlights opportunities to improve disclosure proposals for example, by more clearly specifying the information required to be disclosed; and

(c) common digital reporting practice highlights opportunities to improve the wording of items of information or to develop illustrative examples, and thereby to improve the IFRS Accounting Taxonomy elements, potentially leading to entities providing more comparable information and creating fewer extensions.

IFRS Accounting Taxonomy elements would only be created for information required by an Accounting Standard or items of information included in the illustrative examples that

accompany the Accounting Standard. In accordance with this Guidance, IFRS Accounting Taxonomy elements would typically be created for: an overall disclosure objective; each specific disclosure objective; each item of information linked to a specific disclosure objective; and any additional items of information included in illustrative examples. The IFRS Digital Reporting team reviews the drafting of proposed disclosure requirements and provides input for effects analysis before the publication of an exposure draft.

18.19 Segment Report in Practice:

Segment reporting requires companies especially those which are multi-product and multi- location to disclose their segment-wise operations in their annual reports as well as in their quarterly reports. The users of financial statements have different utilities for the financial information. The users of accounting information are the stakeholders and they are mainly concerned with financial information of various segments of business. The concept of segment reporting in a formalized form is almost 32 years old. It was proposed in 1974 when the Financial Accounting Standard Board (FASB) of USA issued Statement of Financial Accounting Standards (SFAS) 14. After, this International Accounting Standards Committee issued IAS 14 reporting financial information by segment in 1981. Both SFAS 14 and IAS 14 were revised to make segment reporting more informative. SFAS 14 was revised by the FASB with the issue of SFAS 131 in 1997, whereas IAS 14 was revised in 1998. Now, several countries through the standards issued by their respective national institutions have made the segment reporting mandatory. AS 17 in India mandates listed and other companies to report their financial information by segments. The present case study highlights the segment reporting of Tata Consultancy Services (TCS). How the critical analysis of segment reporting is carried out and how it is useful for the external users? This study develops an empirical proxy for the quality of segment reporting from the data in company's annual reports. Information about an entity's geographical and business segments is relevant in assessing the risks and returns of a diversified or multinational entity for which such information is often difficult or impossible to determine from aggregated data.

Corporate financial reporting entails communication of accounting information through financial statements of a corporate enterprise to various groups concerned with the performance of the enterprise. The requirements and practices of financial disclosures change from time to time, and keep pace with the dynamic business environment. In India, the economic reforms of 1991 gave rise to a volatile business environment. In response, the corporate sector initiated strategic business diversification to combat volatility. The corporate enterprises expanded their scope by including a variety of industries, diverse customer groups, and widely scattered markets. As a result, the practice of financial reporting through consolidated financial statements was found inadequate in providing a detailed picture of their performance. Segmental disclosures were not only peculiar to diversified companies but also to companies operating in specialized line(s) of activity(s). The increasing public interest in corporate affairs, the growing awareness among shareholders to know the details of performance of various sub-units, etc., necessitated formulating principles for reporting financial information about different types of products an enterprise produces and different geographical areas in which it operates. As a result, a separate accounting standard on segment reporting came into effect in India since 2001. This standard has been made mandatory for the companies whose shares or debts are listed or going to be listed, on any recognized stock exchange in India. Moreover, this standard is also mandatory for companies with an annual turnover of ₹500 million or more. Consequently, the corporate enterprises began to comply with this standard in their corporate reporting. Against this background, the

researcher is interested to make an empirical study on segmental disclosures in corporate financial reporting of TCS.

A segment is a part of an organization. The segments are distinguishable components of an enterprise. Each of these segments is engaged in providing different products or in providing services to a wide range of customers. These segments possess different rates of profitability, different levels of risks, and different opportunities for growth. Such differences cannot be easily identified in a consolidated financial report.

Segment reporting can be defined as the disaggregation of the financial statements of a company or a group of companies into different segments covering sales, revenues and profits, line of business, and geographical markets. Large companies with diversified product lines/marketing regions, which may differ from each other with respect to profitability, growth potential and risk, evidently require segment reporting for highlighting different areas. Information about the segment contributes to investment evaluation of corporate enterprises. Investors would be able to assess the company's earning potential, cash flows, risk, and growth. It would also help the management of the company to evaluate the internal management of the company and frame segment specific policies.

18.20 Corporate Disclosure in Practice:

During the past several years, the business community has been fascinated by a debate over the functioning of capital markets and the need for market reform. Contributing to the debate are a variety of academics, investors, financial commentators, and government policymakers who, through published reports and research, are challenging the conventional wisdom of market efficiency and laissez-faire economics. Some have focused on the functioning of the capital markets and its effectiveness in resource allocation. Others have investigated the related topics of financial reporting regulation and corporate governance still others are challenging the financial accounting tradition by arguing for new accounting models that use more non-financial performance measures to capture the returns to strategic investments in technology infrastructure and core competence. The intent of all these reports has been to offer insight into the complex interrelationships among patterns of information flow, capital market efficiency, and the competitive performance of U.S. industrial enterprise.

It is perhaps not surprising that the studies, reports, and articles have generally created more confusion than clarity. Rather than contributing to a single, shared perspective of market functioning, the studies offer a multitude of theories and definitions of market activity that have served only to aggravate the debate, drawing more distinct political and rhetorical boundaries between supporters and critics. On one side of the rhetorical divide are the economists who argue that unfettered markets offer the most economically rational means for capital allocation. They support the basic economic notion that the markets are efficient and, if left to function freely, will allocate capital to maximize risk-adjusted returns. They also tend to believe that a company's stock price is an effective summary statistic of its performance. In general, they see no need to reform market functioning or modify substantively the information flow driving market activity. To buttress their view, these economists point to the liquidity, flexibility, and size of the U.S. markets as evidence of their effective functioning. They also rightly note that U.S. reporting standards are some of the most developed and sophisticated in the world.

On the other side of the debate are the critics. Generally, they argue that the institutional and regulatory structures supporting market activity are flawed and have failed to

provide adequate safeguards against wasteful management and inappropriate corporate investment. They also decry the “short termism” of the markets.

18.21 Summary

Investors, lenders, creditors, and other allocators of capital (collectively “investors”) have observed that segment information is critically important in understanding a public entity’s different business activities. That information enables investors to better understand an entity’s overall performance and assists in assessing potential future cash flows. Disclosures about Segments of an Enterprise and Related Information, indicated overall support from stakeholders for the management approach to segment reporting. That report stated that investors are generally satisfied with the segment note disclosures.

18.22 Key words:

Disclosure: In the financial world, disclosure refers to the timely release of all information about a company that may influence an investor's decision. It reveals both positive and negative news, data, and operational details that impact its business.

Segment practices: Segment reporting requires companies especially those which are multi-product and multi-location to disclose their segment-wise operations in their annual reports as well as in their quarterly reports. The users of financial statements have different utilities for the financial information.

Materiality: Similarly, it is unnecessary for each Accounting Standard to explicitly refer to the need to make materiality judgments when applying disclosure requirements.

Disclosure Requirement: According to AS-17, segment reporting should cover 75% or more of the total revenue of the enterprise. The segments could be business segment or geographic segments. The information can also be presented in a matrix form.

18.23 Self-Assessment Questions

1. What is the disclosure requirement of operating segment?
2. What is objective of disclosure requirement?
3. What is specific disclosure requirement?
4. Explain the segment practices in India.

18.24 Suggested Reading

1. Multinational Accounting (RLE Accounting): Segment Disclosure and Risk (Routledge Library Editions: Accounting) Hardcover – Import, 1 November 2013 by Bimal Pradhan (Author)
2. Amazon.in - Buy Global Financial Accounting and Reporting: Principles and Analysis book online at best prices in India on Amazon.in. Read Global …
3. Corporate Segment Reporting: Theory and Practice Hardcover – 1 January 2016 by Seema Srivastava (Author)
4. Segment Reporting practices in India: A case study of TCS Ltd Paperback by Bhagavan Das (Author, Contributor)
5. Disclosure Criteria and Segment Reporting (Unit Off Accounting Series No. 10) Paperback Import, 1 March 1989 by Rassel M. Barefield. (Editor), Gary L. Holst rum Editor)
6. Practical Guide to Ind-AS & IFRS – Latest ***8th Edition 2023*** by CA Kamal Garg – Bharat
7. Segment reporting: theoretical analysis and empirical approach in Greek enterprises Charalambos. T. Spathes Pages 804-807 | Published online: 07 Dec 2010 Cite this article https://doi.org/10.1080/09638189700000021

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Lesson-19

INTERNATIONAL FINANCIAL REPORTING

Learning Objectives:

- ✓ To learning the meaning and objectives of Financial Reporting
- ✓ To understand the scope of Financial Reporting
- ✓ To know the difference between IFRS and US GAAP
- ✓ To study the IFRSS in Indian Perceptive
- ✓ To determine the Interim Financial Reporting

Structure:

19.0 Introduction
19.1 Meaning of IFRS:
19.2 Why IFRS?
19.3 Objectives of IFRS:
19.4 Scope of IFRS
19.5 Difference between IFRS and us GAAP standards
19.6 Convergence with IFRSs: Indian perspective
 19.6.1 Inventory valuation methods
 19.6.2 Cash flow statement
 19.6.3 Balance sheet
 19.6.4 Asset revaluation
 19.6.5 Inventory write-down reversals
 19.6.6 Development costs
19.7 Financial reporting under us GAAP
19.8 Convergence with IFRSs: Indian perspective
19.9 Benefits of IFRS
19.10 IFRS -1: first time adoption of IFRS
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19.0 Introduction

Accounting is the art and science of recording business transactions in best possible manner with proper selection and adoption of accounting policies and principles. Over the time it was felt necessary to ensure easy comparability the enterprises should follow uniform accounting methods. In India the Institute of Chartered Accountants of India governs the profession of accountancy. The institute ensures professionalism and prudence in preparation and presentation of financial statements by issuing guidelines, accounting standards from time to time. In today's world of globalization business enterprises have become more dependent on each other, across the nation and across the world. The globalization has forced more and more countries to open their doors for business expansion across borders and to foreign investments. Traditionally companies raised funds from domestic capital markets and financial institutions. The business

was restricted to very few countries. The rapid expansion of international trade and internationalization of firms, the development of new communication technologies, and the 514 emergences of international competitive forces has made it extremely necessary to have uniform and internationally acceptable accounting standards. Now it has been realized that under this global business scenario the business community is badly in need of a common accounting language that should be spoken by all of them across the world. A financial reporting system supported by a strong governance, high quality standards and firm regulatory framework is the key to economic development.

Indeed, sound financial reporting standards underline the trust that investors place in financial reporting information and thus play an important role in contributing to the economic development of a country. Different countries have local accounting standards which spell out the accounting treatment and disclose your requirements for preparing of financial statements, some sort of compatibility or convergence is necessary to enable all the stake holders to take appropriate economic decisions. This is sought to be ensured through the International Financial Reporting Systems (IFRS) adopted by International Accounting Standards Board (IASB). Most of the countries have started adopting IFRS or making their local GAAP convergent with IFRS. Major stock exchanges across the world today accept IFRS.

19.1 Meaning of IFRS: IFRSs are principle-based standards.

- The principle-based standards have distinct advantage that the transactions cannot be manipulated easily to achieve a particular accounting.

- The Financial Accounting Standards Board (FASB), USA, is having a convergence project with the IASB and is broadly adopting the principle-based approach instead of rule-based approach.

- IFRSs lay down treatments based on the economic substance of various events and transactions rather than their legal form.

- The application of this approach may result into events and transactions being presented in a manner different from their legal form.

- To illustrate, as per IAS 32, preference shares that provide for mandatory redemption by the issuer are presented as a liability.

19.2 Why IFRS?

A single set of accounting standards would enable internationally to standardize training and assure better quality on a global screen, it would also permit international capital to flow more freely, enabling companies to develop consistent global practices on accounting problems. It would be beneficial to regulators too, as a complexity associated with needing to understand various reporting regimes would be reduced.

19.3 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.

19.4 Scope of IFRS

All International Accounting Standards (IASs) and Interpretations issued by the former IASC (International Accounting Standard Committee) and SIC (Standard Interpretation Committee) continue to be applicable unless and until they are amended or withdrawn. IFRSs apply to the general-purpose financial statements and other financial reporting by profit-oriented entities -- those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form. Entities other than profit-oriented business entities may also find IFRSs appropriate. General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows. Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions. IFRS apply to individual company and consolidated financial statements. A complete set of financial statements includes a balance sheet, an income statement, a cash flow statement, a statement showing either all changes in equity or changes in equity other than those arising from investments by and distributions to owners, a summary of accounting policies, and explanatory notes. If an IFRS allows both a 'benchmark' and an 'allowed alternative' treatment, financial statements may be described as conforming to IFRS whichever treatment is followed. In developing Standards, IASB intends not to permit choices in accounting treatment. Further, IASB intends to reconsider the choices in existing IASs with a view to reducing the number of those choices. IFRS will present fundamental principles in bold face type and other guidance in non-bold type (the 'black-letter'/'grey-letter' distinction). Paragraphs of both types have equal authority. The provision of IAS 1 that conformity with IAS requires compliance with every applicable IAS and Interpretation requires compliance with all IFRSs as well.

19.5 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.
Research and Development	Allows for capitalization under specific conditions.	Generally, R&D costs are expensed as incurred.
Extraordinary Items	IFRS does not define extraordinary items.	US GAAP allows for the reporting of extraordinary items.
Reversal of Impairment	Permits the reversal of impairment losses for certain assets.	More restrictive on impairment reversal.
Fair Value Measurement	Emphasizes fair value measurement, with fair value hierarchy.	Provides more specific guidance on fair value measurement.
Business Combinations	Goodwill impairment testing is done at the cash-generating unit (CGU) level.	Goodwill impairment testing is done at the reporting unit level.
Revenue Recognition	IFRS 15 (IFRS) and IAS 18 (previous standard) for revenue recognition.	ASC 606 (US GAAP) for revenue recognition.
Leases	IFRS 16 (IFRS) for lease accounting.	ASC 842 (US GAAP) for lease accounting.
Presentation of Financial Statements	IFRS focuses on the statement of financial position, statement of profit or loss and other comprehensive income, and statement of changes in equity.	US GAAP includes the balance sheet, income statement, statement of comprehensive income, and 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.
Income Taxes	Deferred tax assets and liabilities are recognized based on the balance sheet approach.	Deferred tax assets and liabilities are recognized based on the liability method.

19.6 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.

There are other notable differences in how GAAP and IFRS handle specific elements of various financial documents, including:

19.6.1 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.

19.6.2 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.

19.6.3 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 first—that 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.

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

19.6.5 Inventory write-down reversals:

A company's inventory may lose value over time. An asset may, for example, lose value because of market or technological factors, which classifies it as a "loss on impairment." GAAP and IFRS require that businesses write down their inventory as soon as its cost exceeds its net realizable value (i.e., how much the inventory is expected to generate when sold). While a loss is often permanent, the value of an asset may increase again if the impairing factor is no longer

present. GAAP doesn't allow companies to re-evaluate the asset to its original price in these cases. In contrast, IFRS allows some assets to be evaluated up to their original price and adjusted for depreciation.

19.6.6 Development costs:

In accounting, development costs are the internal costs of developing intangible assets - assets with no physical form, like patents, intellectual property, and client relationships. GAAP considers these expenses, while IFRS allows companies to capitalize and amortize them over multiple periods. Your accounting standard, therefore, determines where on your financial documents you must list intangible assets and affects your balance sheet's final balance.

19.7 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.

Though a company is not obligated to file an interim financial report, some areas may still require you to do so because of the local laws. While issuing any kind of financial statement, certain regulations need to be followed. IFRS and GAAP standards can be different in some aspects and you need to be aware of them, especially the companies reporting for dual filers and those opting for conversion. Here are the major differences between IFRS and GAAP standards.

The US GAAP offers some leniency on cost allocation to interim periods based on the expired time estimation, benefits, and other factors linked to the interim period. IFRS standards, on the other hand, do not provide any leniency here. The costs can be deferred at the interim reporting date only if the same can be done at the annual reporting date. There are also certain GAAP rules for property taxes that may not comply with the IFRS standards.

Under IAS 34 of IFRS standards, if any losses have occurred due to variation in costs, they should be mentioned in the interim period of their occurrence. The company should not wait to include them in the annual fiscal year report. However, the US GAAP standard allows such losses to be deferred because interim financial statements are a crucial part of the annual reports.

The IFRS standards ensure that companies account for alterations in tax laws enacted during an interim period. It advises the companies to do so either by mentioning the change in its occurrence of the interim period or by adjusting the estimated annual effective tax rate. But the US GAAP expects companies to recognize the tax changes in the interim period statement only.

Companies with exposure to numerous tax countries and distinct taxable income categories should file individual effective tax rates for each jurisdiction and income category under IFRS Standards. If utilizing more particular rates might result in a realistic approximation of the effect, a weighted-average rate across jurisdictions is utilized. The US GAAP is slightly different here, it allocates the projected annual income tax expense or benefit to interim periods using a single overall estimated annual effective tax rate.

19.8 Convergence with IFRSS: Indian perspective:

- Indian Accounting Standards (ASs) are formulated on the basis of the IFRSs.
- While formulating ASs, the endeavor of the ICAI remains to converge with the IFRSs.
- The ICAI has till date issued 29 AS corresponding to IFRSs.
- Some recent ASs, issued by the ICAI, are totally at par with the corresponding IFRSs, e.g., the Standards on 'Impairment of Assets' and 'Construction Contracts'.
- While formulating Indian Accounting Standards, changes from the corresponding IAS/ IFRS are made only in those cases where these are unavoidable considering:
- Legal and/ or regulatory framework prevailing in the country.
- To reduce or eliminate the alternatives so as to ensure comparability.
- State of economic environment in the country
- Level of preparedness of various interest groups involved in implementing the accounting standards.

19.9 Benefits of IFRS:

The forces of globalization prompt more and more countries to open their doors to foreign investment and as businesses expand across borders the need arises to recognize the benefits of having commonly accepted and understood financial reporting standards. Following are 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

19.10 IFRS -1: First time adoption of IFRS

An entity shall prepare and present an opening IFRS statement of financial position at the date of transition to IFRSs. This is the starting point for its accounting under IFRSs. An entity shall prepare an opening IFRS balance sheet at the date of transition to IFRSs. This is the starting point for its accounting under IFRSs. An entity need not present its opening IFRS balance sheet in its first IFRS financial statements. In general, the IFRS requires an entity to comply with each IFRS effective at the end of its first IFRS reporting period. In particular, the IFRS requires an entity to do the following in the opening IFRS statement of financial position that it prepares as a starting point for its accounting under IFRSs:

- Recognize all assets and liabilities whose recognition is required by IFRSs.
- Not to recognize items as assets or liabilities if IFRSs do not permit such recognition; IFRS-1.
- IFRS-1 reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are different type of asset, liability or component of equity under IFRSs. Apply IFRSs in measuring all recognized assets and liabilities.

The IFRS grants limited exemptions from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The IFRS also prohibits retrospective application of IFRSs in some areas; particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known. The IFRS requires disclosures that explain how the transition from previous GAAP to IFRSs affected the entities reported financial position, financial performance and cash Flows.

Globally, the IFRS is gradually gaining acceptability. As discussed in the previous section, the need to speak a uniform accounting language led to the development of IFRSs. Thus, this section discusses the IFRS and IAS, the IFRS interpretation committee and gave a highlight of available IAS and IFRS.

The term IFRS consists of IFRS issued by International Accounting Standards Board (IASB); International Accounting Standard (IAS) issued by International Accounting Standard Committee (IASC); and interpretations issued by the standard interpretations Committee (SIC) and the International Financial Reporting Interpretation Committee (IFRIC). The International Accounting Standard states how particular types of transactions and other events should be reported in financial statements. The standards issued by IASC were known as IAS. In 2000, IASC member bodies approved the restructuring of IASC's foundation and in March 2001, the new IASB took over the responsibility of setting the international Accounting Standards from IASC. IASB adopted the standards set by IASC and continued to develop new standards and called the new standards – IFRS. Both IFRS and IAS are equally enforceable because there is no

difference between the two (Ikpefan&Akande, 2012). The predecessor of the IASB, the International Accounting Standards Committee (IASC), was founded in June 1973. Its creation was related to that of the International Federation of Accountants (IFAC), which is the worldwide umbrella organization of accountancy bodies. It was independent of government or pseudo-government control. By 1998, the IASC had expanded membership to 140 accountancy bodies in 101 countries. The application of IAS in preparing financial statements did not always result into uniform and comparable financial information simply because similar transactions and events were not necessarily reported in a like way. With the dawn of globalization and increasing demand for transparent, comparable financial information in the markets, and in order to become a world leader in standard setting, it was necessary to change the structure of the IASC at the turn of the century, therefore in 2001, the International Accounting Standard Board (IASB) replaced IASC. The IASB formulates IFRSs and further enforce the compliance of IAS that does not have IFRS equivalent. As discussed in the previous unit, IFRS has been adopted by over 100 countries around the globe, Nigeria inclusive.

The interpretative body of the IFRS foundation earlier discussed is the IFRS interpretations committee (IFRIC) formally known as Standing Interpretations Committee (SIC). They are saddled with the responsibility of reviewing on a timely basis widespread accounting issues that have arisen within the contexts of IFRS and IAS. It provides appropriate guide on accounting issues and reaches consensus on the appropriate treatment for these issues. This committee comprises of 14 voting members drawn from a variety of countries and professional backgrounds, they are appointed by the Trustees of the IFRS foundation and are selected for their ability to maintain an awareness of current issues as they arise and the technical ability to resolve them (Olanrewaju, 2012). These interpretations have the same authority as a standard issued by the IASB. A total of 19 IFRIC has been issued as at 2017. In the quest for high quality financial reports, IFRS was formulated as a high-quality accounting standard to promote uniform financial reporting across the globe. The IFRSs consist of IFRS by IASB, IAS issued by IASC, and IFRIC.

19.11 Summary

International Financial Reporting Standards (IFRS) is an abbreviation for international financial reporting standards. The set of accounting rules and regulations that govern how accounting events should be reported in your company's financial statements is referred to as the accounting framework. The International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board (IASB) with the goal of making financial statements consistent, comparable, and transparent throughout the world. The United States is one famous country that does not adhere to the International Financial Reporting Standards (IFRS), instead of using a system known as GAAP.

19.12 Keywords:

IFRS: For the purposes of IFRS 1, the date of transition to IFRSs is the beginning of the earliest period for which the entity presents full comparative information under IFRSs in its first IFRS financial statements. The opening IFRS balance sheet is prepared at this date. Entities are not required to present their opening IFRS balance sheets in their first IFRS financial statements.

GAAP: Generally accepted accounting principles (GAAP) refer to a common set of accounting rules, standards, and procedures issued by the Financial Accounting Standard Board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements.

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:

Development Cost: In accounting, development costs are the internal costs of developing intangible assets -assets with no physical form, like patents, intellectual property, and client relationships. GAAP considers these expenses, while IFRS allows companies to capitalize and amortize them over multiple periods. Your accounting standard, therefore, determines where on your financial documents you must list intangible assets and affects your balance sheet's final balance.

19.13 Self - Assessment questions:

1. Explain the meaning and scope of IFRS.
2. What are the objectives of IFRS?
3. What is the significance of the International Accounting Standards Board?
4. What is interim report? Explain the interim report.

19. 14 Suggested Readings:

1. International Financial Reporting: A Practical Guide Paperback – 23 July 2009 by Alan Melville (Author)
2. Suggestions for reforming the governance of global accounting standard Publishing date 12 May 2011 Authors
3. Applying International Accounting Standards Paperback – Import, 29 March 2005by Keith Alfredson (Author), Ken J. Leo (Author), Ruth Picker (Author), Paul Pacter (Author), Jennie Radford (Author)
4. International Accounting Standards: from UK standards to IAS, an accelerated route to understanding the key principles of international accounting rules Show full title By Paul Rodgers.
5. Difference Between IAS And IFRS Abhishek Bhardwaj May 16, 2023 the New Head of the International Accounting Standards Board Outlines His Priorities Andreas Barckow became chairman of the global accounting rule maker in July by Mark Maurer Sept. 6, 2021 10:00 am ET
6. Understanding IFRS Fundamentals International Financial Reporting Standards by Nandakumar Ankarath, Kalpesh J. Mehta, T. P. Ghosh, Yass A. Alkafaji

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Lesson-20

INTERIM FINANCIAL REPORTING

Learning Objectives

- ✓ To understand the objectives and key aspects of interim financial reporting
- ✓ To know the scope of interim financial reporting
- ✓ To learn the components of interim financial reporting
- ✓ To identify the standards of interim financial report
- ✓ To study the disclosure in annual financial statements

Structure

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20.0 Introduction

Investors, shareholders, and the general public expect companies to disclose their financial reports for the clarity of the company's standing in the market. This clarification helps the Investors understand how their money is being used, the shareholders understand if their investment in the company has growth or not, and the general public can make a well aware decision of investing in the company. The best way of providing investors and the general public with an up-to-date financial report of a company is through an interim financial report or statement. As the name suggests, it refers to the financial report of a company covering a time span of less than a year. The report is filed before the annual financial reporting cycle. The reports are filed for a duration of last six or five months, or whatever as per your preference.

Interim reports come in handy when you want to let the investors, analysts, and shareholders know about your company's financial performance within a specific period of time. These reports are commonly filed by companies to also highlight the material changes to the general public. As simple as it sounds, some complex features can easily confuse you. This is why acquiring a thorough knowledge of the subject is necessary. Here is a complete guide that can help you understand the Interim Financial Statement and its various characteristics in detail. It will also deliver useful insights on the importance and benefits of filing an Interim Financial Report and the process of filing it.

The financial statements that are filed by a company for a period of less than a year, are referred to as interim financial statements or reports. The primary objective of filing an interim financial statement is to provide an insight into your company's financial performance and material changes to shareholders and analysts. These statements are most often issued by publicly-held companies and are not audited.

IAS 34 applies if a company or organization publishes an interim financial report that follows all the standards necessary for IFRS Standards. These statements can be issued in any period prior to the financial year. Just like any other official statement, certain rules and standards need to be maintained while filing an interim statement. As suggested by the International Accounting Standards Board, the following aspects should be clearly mentioned in an interim financial statement.

Income Statements indicating the firm or issuing entity's financial position Condensed statement of profit and loss Alterations in equity with explanatory notes. An interim financial report is very beneficial as it provides a timely view of a company's operations and financial aspects. With an interim financial report, you don't have to wait for an entire year for accessing this information. Also, the year-end financial reports take months to access even after they have been released. Another major benefit of releasing these reports is the shareholders, public, and analysts are informed about major company changes like bankruptcy, the resignation of directors, and an alteration in the fiscal year.

A good example of such a report is a quarterly financial statement as it is issued before year-end within a period of 3 months. It is a concise report of unaudited financial statements, which include income reports, balance sheet, cash flow reports, etc. Quarterly statements are filed within a few weeks after the quarter period has ended.

When looked from an analytic perception, Interim and annual financial statements are fairly the same with similar aspects like income reports, balance sheets, and cash flow statements. However, there are a few differences that are vividly noticed between the two. The most obvious is the coverage period, which is a complete year for the annual financial reports and less than a year for the Interim statements. An interim report also should not necessarily have some disclosures that are required in an annual one. Interim reports can be shorter than the Annual reports.

20.1 Objective of Interim Financial Reporting:

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and Liquidity.

20.2 Scope of Interim Financial Reporting:

This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period. However, governments, securities regulators, stock exchanges, and accountancy bodies often require entities whose debt or equity securities are publicly traded to publish interim financial reports. This Standard applies if an entity is required or elects to publish an interim financial report in accordance with Indian Accounting Standards (Ind ASs).

Each financial report, annual or interim, is evaluated on its own for conformity to Ind ASs. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with this Standard does not prevent the entity's annual financial statements from conforming to Ind ASs if they otherwise do so.

If an entity's interim financial report is described as complying with Ind ASs, it must comply with all of the requirements of this Standard. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise 3. The requirements related to cash flow statement, complete or condensed, contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.

20.3 Definitions of Interim Financial Report:

Interim financial report means a financial report containing either a complete set of financial statements (as described in Ind AS 1, Presentation of Financial Statements, or a set of condensed financial statements (as described in this Standard) for an interim period.

20.4 Content of an interim financial report:

Ind AS 1 defines a complete set of financial statements as including the following Components:

(a) a balance sheet as at the end of the period;
(b) a statement of profit and loss for the period;
(c) a statement of changes in equity for the period;
(d) a statement of cash flows for the period;
(e) notes, comprising a summary of significant accounting policies and other explanatory information; comparative information in respect of the preceding period as specified.
(f) a balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements. This Standard defines the minimum content of an interim financial report as including condensed financial statements and selected explanatory notes. The interim financial report is intended to provide an update on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.

Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in Ind AS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. Nor does this Standard prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement guidance in this Standard applies also to complete financial statements for an interim period, and such statements would include all of the disclosures required by this Standard (particularly the selected note disclosures in paragraph 16A) as well as those required by other Ind ASs. This Standard does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. This Standard also does not prohibit or discourage an enterprise from including, in condensed interim financial statements, more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Standard.

20.5 Periods for which Interim Financial Statements are required to be presented:

Interim reports should include interim financial statements (condensed or complete) for periods as follows:

(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;
(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;
(c) cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year to date period of the immediately preceding financial year.

For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful. Accordingly, enterprises whose business is highly seasonal are encouraged to consider reporting such information in addition to the information called.

20.6 Minimum components of an interim financial report:

An interim financial report shall include, at a minimum, the following components:

(a) a condensed balance sheet;

(b) a condensed statement of profit and loss;

(c) a condensed statement of changes in equity;

(d) a condensed statement of cash flows; and

(e) selected explanatory notes.

Form and content of interim financial statements:

- If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements shall conform to the requirements of Ind AS 1 for a complete set of financial statements.
- If an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements shall include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard. Additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading.
- If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with Accounting Standard (AS) 20, Earnings Per Share, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim.
- If an enterprise's annual financial report included the consolidated financial statements in addition to the parent's separate financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

20.7 Standards to Be Included in the Interim Financial Report:

The government of India has no law on mandatory filing of interim financial reports. the IFRS or International Financial Reporting Standards do not make it mandatory for firms to file an interim financial report, many companies do that either by choice or because of the local regulations.

- ➢ Companies aiming to file an interim financial statement should submit it in a ‘condensed’ format. In this case, the simplified presentation and disclosure requirements of IAS 34 apply. The following standards need to be included in an Interim financial report:

- Condensed statement for the financial position: This should contain information till the end of the current interim period and at the completion of the immediately next financial year.
- Condensed statement of profit or loss: This condensed statement requires all the profit and loss information of the current interim period and for the year to date.
- Condensed statement of equity changes: Should be filed for the ongoing year to date and also for the interim period of the next financial year, which will be considered for comparison.
- Condensed statement of cash flows: The statement should include details like the sources of cash flows, and other information for the current year to date and the next financial year.
- Self-explanatory notes: For condensed financial statements, headings and sub-totals should be necessarily included along with self-explanatory notes.

20.8 Need to File an Interim Financial Statement:

The government of India or the law of the country in no sense makes it mandatory to file an interim financial statement. But it is regarded as a healthy practice and in some areas, even the local laws may make these reports a necessity at times in certain cases. A primary benefit of filing an interim financial report is you can find great insights into how your company is performing before the year-end. Following are the major advantages of interim statements:

1. **Protection From Future Troubles:** When you file an interim financial statement of your company, you gather lots of details like the cash flow, revenue, equity changes, etc. This helps in analysing your company's performance and also detecting troubles if any. Since these statements are filed before the end of a fiscal year, you would have enough time to strategize your business and recover losses or financial issues that have occurred. So, Interim Financial Reports can actually safeguard you from future financial troubles.
2. **Thorough Bookkeeping:** Filing an interim financial statement requires a multitude of information, which you can utilize for further growth. You have all the information in one place and this can assist you in keeping a record of every minute financial detail. You will have the crucial information at your disposal whenever you require it.
3. **Easy Loans:** The best part of filing an interim financial report is you can get assistance in getting quick bank loans. With the previous fiscal year long gone, you may be asked about your company's fresh financial records. An interim report can provide proof that you are not in debt and that the company is capable enough to afford a business loan. An interim statement will portray a positive image of your company in front of the bank.
4. **Higher Chances of Closing a Deal:** Clients often prefer a detailed overview of your company's financial performance before closing a deal. A yearly report may not easily convince them if the previous year is long gone. So, you need something fresh to present to them. This is where the Interim Financial Statements can make your day. These fresh details will increase your chances of getting the deal and impressing your client.
5. **Effective Future Planning:** With an overview of your company's financial condition to date, you will have an opportunity of mending and fix points where you could have done better. This will help you plan the future course of action with more precision.

Reports have also revealed that firms and companies that provided appropriate and timely interim financial reports were able to obtain covid relief funding. Your chances of attaining such opportunities go up when you have all the details of the company's financial information and tax returns.

20.9 The Most Important Part of Interim Reports: Profit and Loss Statement:

The most important and commonly used part of an interim financial statement is the profit and loss part and the balance sheet. With a piece of clear information on your company's profit and cash flow, you will have an idea of how it's performing. Keeping a close eye on expenses will assist you in finding out new ways of earning more money to cover those expenses.

If you wait for an annual financial statement, then you can easily miss out on many opportunities. Sometimes companies fail to track their records of losses and enter into huge debts. A regular review of your income can assist you in avoiding such circumstances. A balance sheet is a summary of what your business owns and owes during a specific time duration. Despite getting an annual one, you can gather a balance sheet for an interim period to get a fair idea of your debts, loans, and revenue.

Keeping a close eye on these two aspects and reviewing them regularly can help you pick out the negative and positive alterations occurring in your company. You will have a more vivid idea of aspects like the total equity, expenses, retained earnings, working capital, cash flow, etc. Generating these reports at least quarterly can provide you with deep insights and benefit your business in ways you can't even imagine. Having a crystal-clear sight of every minute financial detail of your company will yield positive results.

20.10 Selected Explanatory Notes:

A user of an enterprise's interim financial report will ordinarily have access to the most recent annual financial report of that enterprise. It is, therefore, not necessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual financial report. At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date is more useful.

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

a. A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;
b. explanatory comments about the seasonality of interim operations;
c. the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature and size. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies);

d. the nature and number of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;
e. issuance, buy-backs, repayments and restructuring of debt, equity and potential equity shares;
f. dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;
g. segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements);
h. material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;
i. the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and
j. material changes in contingent liabilities since the last annual balance sheet date. The above information should normally be reported on a financial year to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

Other Accounting Standards specify disclosures that should be made in financial statements. In that context, financial statements mean complete set of financial statements normally included in an annual financial report and sometimes included in other reports. The disclosures required by those other Accounting Standards are not required if an enterprise's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements. In the statement that presents the components of profit or loss for an interim period, an entity shall present basic and diluted earnings per share for that period when the entity is within the scope of Ind AS 33, Earnings per Share.

An interim financial report is prepared on a consolidated basis if the entity's most recent annual financial statements were consolidated statements. The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. If an entity's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, this Standard neither requires nor prohibits the inclusion of the parent's separate statements in the entity's interim financial report.

20.11 Materiality:

In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognized that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. The Preface to the Statements of Accounting Standards states that

"The Accounting Standards are intended to apply only to items which are material".

The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, states that:

> "Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information".

Judgement is always required in assessing materiality for financial reporting purposes. For reasons of understand ability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognized and disclosed based on materiality in relation to interim period data.

20.12 Disclosures in interim financial reporting:

In addition to disclosing significant events and transactions in accordance with an entity shall include the following information, in the notes to its interim financial statements, if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis.

(a) a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.
(b) explanatory comments about the seasonality or cyclicality of interim operations.
(c) the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence.
(d) the nature and number of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years.
(e) issues, repurchases and repayments of debt and equity securities.
(f) dividends paid (aggregate or per share) separately for ordinary shares and other shares.
(g) the following segment information (disclosure of segment information is required in an entity's interim financial report only if Ind AS 108, Operating Segments, requires that entity to disclose segment information in its annual financial statements):

i. revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
ii. inter segment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
iii. a measure of segment profit or loss.
iv. a measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there

has been a material change from the amount disclosed in the last annual financial statements for that reportable segment.

v. a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss.

vi. a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation.

(h) events after the interim period that have not been reflected in the financial statements for the interim period. The effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by Ind AS 103, Business Combinations.

(i) for financial instruments, the disclosures about fair value required by Financial Instruments: Disclosures.

(j) for entities becoming, or ceasing to be, investment entities, as defined in Ind AS 110, Consolidated Financial Statements, the disclosures in Ind AS 112, Disclosure of Interests in Other Entities paragraph 9B. The disaggregation of revenue from contracts with customers required by paragraphs 114–115 of Ind AS 115, Revenue from Contracts with Customers. Disclosure of compliance with Ind Ass.

If an entity's interim financial report is in compliance with this Standard, that fact shall be disclosed. An interim financial report shall not be described as complying with Ind ASs unless it complies with all of the requirements of Ind ASs. Periods for which interim financial statements are required to be presented. Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

a. balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year.
b. statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.
c. statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
d. statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

e. For an entity whose business is highly seasonal, financial information for the twelve months up to the end of the interim period and comparative information for the prior twelve-month period may be useful.

20.13 Disclosure in Annual Financial Statements:

. An enterprise may not prepare and present a separate financial report for the final interim period because the annual financial statements are presented. requires certain disclosures to be made in the annual financial statements for that financial year. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with AS 5 requirements and is intended to be restricted in scope so as to relate only to the change in estimates. An enterprise is not required to include additional interim period financial information in its annual financial statements.

20.14 Recognition and Measurement Same Accounting Policies as Annual:

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognizing assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements. To illustrate:

A. the principles for recognizing and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognized and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognized amount;
B. a cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

C. income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes. Under the Framework for the Preparation and Presentation of Financial Statements, recognition is the "process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition". The definitions of assets, liabilities, income, and expenses are fundamental to recognition, both at annual and interim financial reporting dates. For assets, the same tests of future economic benefits apply at interim dates as they apply at the end of an enterprise's financial year. Costs that, by their nature, would not qualify as assets at financial year end would not qualify at interim dates as well. Similarly, a liability at an interim reporting date must represent an existing obligation at that date, just as it must at an annual reporting date. Income is recognized in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognized in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

In measuring assets, liabilities, income, expenses, and cash flows reported in its financial statements, an enterprise that reports only annually is able to take into account information that becomes available throughout the financial year. Its measurements are, in effect, on a year-to-date basis. An enterprise that reports half-yearly, uses information available by mid-year or shortly thereafter in making the measurements in its financial statements for the first six-month period and information available by year- end or shortly thereafter for the twelve-month period. The twelve-month measurements will reflect any changes in estimates of amounts reported for the first six-month period. The amounts reported in the interim financial report for the first six-month period are not retrospectively adjusted. Hhowever, that the nature and amount of any significant changes in estimates be disclosed. An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Hhowever, that the nature and amount of any significant changes in estimates be disclosed.

20.15 Revenues Received Seasonally or Occasionally:

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year. Examples include dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognized when they occur.

20.16 Costs Incurred Unevenly During the Financial Year:

Costs incurred unevenly during the financial year that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

20.17 Use of Estimates:

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

20.18 Restatement of Previously Reported Interim Periods:

A change in accounting policy, other than one for which the transition is specified by an Accounting Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year. One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle is to require that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

20.19 Transitional Provision:

Transitional provision the first occasion that an interim financial report is presented in accordance with this Standard, the following need not be presented in respect of all the interim periods of the current financial year: Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

20.20 Significant events and transactions:

An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report. 15A A user of an entity's interim financial report will have access to the most recent annual financial report of that entity. Therefore, it is unnecessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was reported in the notes in the most recent annual financial report. 15B The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.

(a) the write-down of inventories to net realizable value and the reversal of such a write-down;

(b) recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, assets arising from contracts with customers, or other assets, and the reversal of such an impairment loss;
(c) the reversal of any provisions for the costs of restructuring;
(d) acquisitions and disposals of items of property, plant and equipment;
(e) commitments for the purchase of property, plant and equipment;
(f) litigation settlements;
(g) corrections of prior period errors;
(h) changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognized at fair value or amortized cost;
(i) any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;
(j) related party transactions;
(k) transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;
(l) changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and
(m) changes in contingent liabilities or contingent assets.

Individual Ind ASs provide guidance regarding disclosure requirements for many of the items listed in paragraph 15B. When an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual reporting period, its interim financial report should provide an explanation of and an update to the relevant information included in the financial statements of the last annual reporting period.

20.21 Comparative Financial Statements:

Financial Statements are prepared to know the profitability and financial position of the business in the market. The content of a financial statement does not reveal the earning capacity, financial soundness, and liquidity of a company. The users cannot easily understand them; therefore, the data is analyzed for presenting it in a simple and understandable form. Different tools used for the analysis of financial statements are Comparative Statements, Common Size Statements, Trend Analysis/Ratios, Accounting Ratios/Ratio Analysis, Cash Flow Statement, Funds Flow Statement, and Break-Even Point Analysis.

A comparative statement is a document used to compare a particular financial statement with in period of statements. Previous financials are presented alongside the latest figures in side-by-side columns, enabling investors to identify trends, track a company's progress and compare it with industry rivals. For the estimation of an organization's future progress, it is essential to look into its past performance, for which performing a comparative study of two or more years of company financial statements becomes necessary. A statement that helps in the comparative study of the components of a company's balance sheet and income statement over a period of two or more years, both in absolute and percentage form, is known as a Comparative Statement. It is a horizontal type of analysis and not only provides the absolute figures of various years but also, the columns to indicate any increase or decrease in these figures from one year to

another in absolute and in percentage form. One can form an opinion on the progress of an enterprise based on the comparative statements.

When the comparative statements of two or more years of a firm are presented and compared, it is known as inter-period comparison or intra-firm comparison. However, when the comparative statements of two or more firms are compared over a number of years, then it is known as an inter-firm comparison. Comparative Analysis is the study of the trend of same items, groups of items, compound items in two or more financial statements of the same business enterprise of different dates.

20.22 Importance of Comparative Statements:

The importance of Comparative Statements are as follows:

1. **To make the data simpler and more understandable:** The main aim behind the preparation of Comparative Financial Statements is to put the data for a number of years in a simple and comparable form. When the data for a number of years are put side by side, the comparison between their figures becomes easier. Besides, one can also easily draw conclusions regarding the operating results and financial health of the company/companies.
2. **To indicate the strong points and weak points of the concern:** By making a comparison between the financial statements for a number of years, one can also indicate the strong and weak points of the firm. With these strong and weak points, the management of the firm can then investigate and find out the reasons for its weak points and can take corrective measures.
3. **To indicate the trend:** The Comparative Financial Statements of a company indicate its trend of change by putting the figures of revenue from operations, production, expenses, profits, etc., for a number of years, side-by-side. For example, If the Cost of Production is increasing over the years along with an increase in its expenses, it indicates that the business is not in good condition and needs to perform some corrective measures.
4. **To compare the firm's performance with the average performance of the industry:** With the help of Comparative Financial Statements, a business unit can compare its performance with the average performance of the industry.
5. **To help in forecasting**: By performing a comparative study of the changes in the key figures of a company over a period can help its management in forecasting the profitability and financial soundness of the business.
6. **To make data comparable:** When an organization is preparing comparative financial statements, it should put the data in a comparable form, as it will facilitate comparison and will help the company in drawing conclusions regarding its operating and financial performance.
7. **To indicate the soundness of an enterprise:** The Comparative Financial Statements of a Company also indicate its weakness and soundness about its liquidity, profitability, and solvency position over a period of time.

20.23 Comparative Statements Work:

Analysts, investors, and business managers use a company's income statement, balance sheet, and cash flow for comparative purposes. They want to see how much is spent

chasing revenues from one period to the next and how items on the balance sheet and the movements of cash vary over time. Ccomparative statements show the effect of business decisions on a company's bottom line. Trends are identified and the performance of managers, new lines of business and new products can be evaluated, without having to flip through individual financial statements.

Comparative statements can also be used to compare different companies, assuming that they follow the same accounting principles. For example, they can show how different businesses operating in the same industry react to market conditions. Reporting just the latest dollar amounts makes it hard to compare the performances of companies of various sizes. Adding prior period figures, complete with percentage changes, helps to eliminate this problem.

20.24 Cash Flow Statement:

Every business must generate sufficient cash inflows to pay for operations. For example, managers may compare the ending balance in cash each month over the past two years to determine if the ending cash balance is increasing or declining. If company sales are growing, the manufacturer requires more cash to operate each month, which is reflected in the ending cash balance. A downward trend in the ending cash balance means that the accounts receivable balance is growing and that the firm needs to take steps to collect cash faster.

20.25 Income Statement:

A percentage of sales presentation is often used to generate comparative financial statements for the income statement the area of a financial statement dedicated to a company's revenues and expenses. Presenting each revenue and expense category as a percentage of sales makes it easier to compare periods and assess company performance. Income statements provide the details about the results of the operations of the business, and comparative income statements provide the progress made by the business over a period of a few years. This statement also helps in ascertaining the changes that occur in each line item of the income statement over different periods. The comparative income statement not only shows the operational efficiency of the business but also helps in comparing the results with the competitors, over different time periods. This is possible by comparing the operational data spanning multiple periods of accounting. The following points should be studied when analyzing a comparative income statement:

1. Compare the increase or decrease in sales with a relative increase in the cost of goods sold
2. Studying the operational profits of the business
3. Overall profitability of the business can be analyzed by an increase or decrease in the net profit

20.26 Steps in preparing a comparative income statement:

The below steps are followed:

1. Specify absolute figures of all the items related to the accounting period under consideration.
2. Determine the absolute change that has occurred in the items of the income statement. It can be achieved by finding the difference between previous year values with the current year values.

3. Calculate the percentage change in the items present in the current statement with respect to previous year statements.

The format of a comparative income statement is as follows:

Comparative Income Statement
for the years ended ...

Particulars	31st March, 2012 (₹)	31st March, 2013 (₹)	Absolute Change (Increase or Decrease) (₹)	Percentage Change (Increase or Decrease) (%)
I. **Revenue from Operations**	...	...	...	...
II. **Other Income**	...	...	...	...
III. **Total Revenue** (I + II)	...	...	...	...
IV. **Expenses**				
(a) Cost of Materials Consumed	...	...	...	...
(b) Purchases of Stock in trade	...	...	...	...
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade	..	...	...	...
(d) Employees Benefit Expenses	...	...	...	...
(e) Finance Cost	...	...	...	...
(f) Depreciation and Amortisation	...	...	...	...
(g) Other Expenses	...	...	...	...
Total Expenses	...	...	...	...
V. **Profit before Tax** (III – IV)	...	...	...	..
(–) **Income Tax**	...	...	...	...
VI. **Profit after Tax**	...	...	...	...

20 .27 Comparative Balance Sheet:

Comparative balance sheet analyses the assets and liabilities of business for the current year and also compares the increase or decrease in them in relative as well as absolute parameters. A comparative balance sheet not only provides the state of assets and liabilities in different time periods, but it also provides the changes that have taken place in individual assets and liabilities over different accounting periods. The following points should be studied when analyzing a comparative balance sheet:

1. The present financial and liquidity position (study working capital)
2. The financial position of the business in the long term

3. The profitability of the business.

20.28 Steps in preparing a comparative balance sheet:

The below steps can be followed:

1. Determine the absolute value of assets and liabilities related to the accounting periods.
2. Determine absolute changes in the items of the balance sheet relative to the accounting periods in question.
3. Calculate the percentage change in assets and liabilities by comparing current year values with values of previous accounting periods. The format of a comparative balance sheet is as follows:

This concludes the topic of Comparative Statements. Students can gain a good understanding of the need for using comparative statements in financial analysis. To learn more such intriguing concepts on Accountancy.

Comparative Balance Sheet
as at ...

Particulars	Previous Year (₹)	Current Year (₹)	Absolute Change (Increase or Decrease) (₹)	Percentage Change (Increase or Decrease) (%)
I. EQUITY AND LIABILITIES				
1. Shareholders' Funds				
(a) Share Capital				
(i) Equity Share Capital	...	...	...	...
(ii) Preference Share Capital	...	...	..	...
(b) Reserves and Surplus	...	...	...	...
2. Non-current Liabilities				
(a) Long-term Borrowings	...	...	...	...
(b) Long-term Provisions	...	...	...	...
3. Current Liabilities				
(a) Short-term Borrowings	...	...	...	...
(b) Trade Payables	...	...	...	..
(c) Other Current Liabilities	...	...	...	...
(d) Short-term Provisions	...	...	...	...
Total	...	...	...	...
II. ASSETS				
1. Non-current Assets				
(a) Fixed Assets				
(i) Tangible Assets	...	...	...	...
(ii) Intangible Assets	...	...	...	...
(b) Non-current Investments	...	...	...	...
(c) Long-term Loans and Advances	...	...	...	...
2. Current Assets				
(a) Current Investments	...	...	...	...
(b) Inventories	...	...	...	...
(c) Trade Receivables	...	...	...	...
(d) Cash and Cash Equivalents	...	...	...	...
(e) Short-term Loans and Advances	...	...	...	...
(f) Other Current Assets	...	...	...	...
Total	...	...	...	...

20.28 Summary

An interim financial report is a complete or condensed set of financial statements for a period shorter than a financial year. IAS 34 does not specify which entities must publish an interim financial report. That is generally a matter for laws and government regulations. IAS 34 applies if an entity using IFRS Standards in its annual financial statements publishes an interim financial report that asserts compliance with IFRS Standards.

20.29 Key words:

Interim Financial Report: Where an entity presents an interim financial report under IAS 34 for part of the period covered by its first IFRS financial statements, and it presented an interim financial report for the comparable interim period of the immediately preceding financial year, each such interim financial report shall include reconciliations.

Disclosures: In addition to disclosing significant events and transactions in accordance with an entity shall include the following information, in the notes to its interim financial statements, if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis.

Materiality: In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality shall be assessed in relation to the interim period financial data. In making assessments of materiality, it shall be recognized that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

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

20.30 Self - aassessment Questions:

1. What is interim financial report?
2. What should an interim financial report include?
3. Explain the components of interim financial report.
4. What is the importance of financial statements?

20.31 Suggested Readings:

1. International Financial Reporting: A Practical Guide Paperback 23 July 2009 by Alan Melville (Author)
2. Financial Reporting including Indian Accounting Standards in 2 Volumes (New Syllabus) by M.P. Vijay Kumar Edition: 2023
3. Suggestions for reforming the governance of global accounting standard Publishing date 12 May 2011 Authors
4. Financial Reporting Made Easy (FR) (Study Material) by Ravi Kanth Miriyala, Sunitanjani Miriyala Edition: 6th Edition, 2023

5. Applying International Accounting Standards Paperback – Import, 29 March 2005by Keith Alfredson (Author), Ken J. Leo (Author), Ruth Picker (Author), Paul Pacter (Author), Jennie Radford (Author)
6. International Accounting Standards: from UK standards to IAS, an accelerated route to understanding the key principles of international accounting rules Show full titlle By Paul Roadgers.
7. Difference Between IAS And IFRS Abhishek Bhardwaj May 16, 2023 the New Head of the International Accounting Standards Board Outlines His Priorities Andreas Barckow became chairman of the global accounting rule maker in July by Mark Maurer Sept. 6, 2021 10:00 am ET
8. Understanding IFRS Fundamentals International Financial Reporting Standards by Nandakumar Ankarath, Kalpesh J. Mehta, T. P. Ghosh, Yass A. Alkafaji
9. Students Guide on Financial Reporting by G Sekar and B Saravana Prasath Edition: 21st Edition, May 2023
10. Financial Statements, Third Edition: A Step-by-Step Guide to Understanding and Creating Financial ReportsThomas Ittelson Apr 2020 · Gildan Media · Narrated by Paul Heitsch

Dr. S. Vijay Kumar

(405CO21)

Model Question Paper

M.Com. (Accountancy)

Second Year - Semester- IV

Paper–IV: International Accounting

Time: Three hours **Maximum: 70 marks**

SECTION A — (4 X 5 = 20 marks)
Answer any FOUR of the following

1. a. Great depression
   b. Auditing and accountability
   c. Hedging
   d. International trade
   e. Global investment
   f. Mergers
   g. Profit split method
   h. Master file
   i. Profitability ratios
   j. Spare capacity

SECTION - B
Answer All of the following.

(5 X 10 = 50 marks)

2. a. What is international accounting? Write its features
   (or)
   b. What are the weaknesses of traditional accounting system?

3. a. Brief the concepts of 'functional currency' and 'presentation currency'.
   (or)
   b. Explain the various types of currency transactions.

4. a. Write different types of price level changes.
   (or)
   k. What factors are influencing on price level changes?

5. a. What are the features of transfer pricing?
   (or)
   b. What are the strengths and weaknesses of profit splitting method?

6. a. What is interim financial reporting? Write its process.
   (or)
   b. Write a note on GAAP.