Why should financial comparisons of multi-national companies with subsidiaries in different countries be undertaken with caution?

A multinational corporation (MNCs) is, "an international or transnational company with its headquarters in one country but branch offices in a wide range of both developed and developing countries"[1] It is generally accepted that a MNC involves producing and selling goods in several different countries. The expansion of corporations internationally tends to be one of the most important goals for continuing success.

The creation of a subsidiary in a new country creates many problems for the corporation. Consideration will be given to both internally and externally financial reporting problems. The focus of this essay will be on the language, currency, Accounting Standards and external audit problems and why caution has to be taken when comparing MNCs.

For MNCs, deciding on what language to use for reporting purpose can be a problem, this is because each subsidiary may have a different native language. Making this decision will depend on the language which is the most recognisable by their portfolio of investors. The majority of the MNCs would produce reports in English or have copies available in English. The language chosen does not tend to be a major problem to investors. This is due to English been well known globally and many investors being multilingual or having access to translation services.[2] Terminology tends to be a bigger problem. An example of this is the American word 'stock' which describes what in the UK is 'shares' and the British use of the word 'stock' is labelled as 'inventory' in the US.[3] The more experienced users of financial statements would understand these problems and as a result they may not be affected. On the other hand the less experienced would find it more difficult to understand.

One of the benefits of having a multinational operation according to David Gayfer is to generate long-term capital in the countries where their are subsidiaries of the MNCs.[4] However, certain stock markets require stringent rules i.e. the New York stock exchange requires accounts to be prepared in accordance to US GAAP. The benefit of obtaining long-term capital could be seen as an incentive for entering into these countries. MNCs would therefore tend to consider countries which have a low gearing ratio therefore strong equity.[5] The stringent rules can have the impact of making some MNCs create two sets of financial reports. The users would then have to decide which financial reports to use. The problem would occur in not knowing which financial report shows a true and fair view. If the financial report was only produced due to the stringent rules then it would most likely be done in order for compliance and not to show a true and fair view.

This brings us onto the issue of which accounting standards should the MNC report in accordance with. Generally, MNCs will report using the standards of the country domiciled by the parent company. They also have to produce a second set of figures in compliance with the local GAAP. This then brings more problems when consolidating the group accounts as different standards are used, unless the subsidiaries was to have a uniform system, which used the same standards as the parent company and recalculated the figures for local reporting.

All usable financial reports need to be stated in one currency. Therefore translation from the foreign currency to local currency is required. Stable currency rates would create no problems. However,

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[1] Lawrence, S (1996), pg 209
[2] Lawerence, S (1996), pg 352
[3] Lawerence, S (1996), pg 352
[4] Gayfer, D (2004), pg 3
[5] Nobes C, 1990

"exchange rates are seldom stable"[6] and as a result it would increase the number of translation rates creating more foreign exchange gains and losses. There are three main exchange rate methods, historical, current and average. The historical exchange rate method would 'shield' whereas the current exchange rate method would 'cause' translation gains and losses.[7] Therefore as different MNCs would use a different method, their financial statements would be incomparable, as they would not have been compared on the same basis. The MNCs would need to decide which currency to report in. This would depend on the location of major investors, areas of business activities, international recognition of currency and the country of domicile both legal and actual.[8]

Within the last five years or so many questions has been raised regarding auditing. The postulation that the high level of potential income that the auditors may receive from a client would influence the result of the audit, raises the question, how credible are the financial reports?[9] The main challenges facing a user of financial reports are the credibility of the figures. The auditing profession has the problem of users not knowing whether the reports comply with the accounting standards. This is mainly due to the users not trusting the audit report, as many scandals have been discovered even when they have been approved by the auditors. Enron and WorldCom had passed their audits, but it was later discovered that the figures were incorrect. The lack of rules on who is allowed to carry out an audit for an MNC makes it very difficult for any users to accept the opinion of the auditor. The Big Five who tend to audit the MNCs are not answerable to anyone, therefore they have more flexibility on the signing off of audits. The problems that face MNCs is whether to have the same audit firm carry out the audit for the whole corporation or to leave it to the subsidiaries to get a local audit firm who has a better understanding of the local accounting standards. By getting the foreign subsidiaries to find their own local auditor it may improve the quality of the audit but it would not be consistent through out the corporation. Auditors would tend to have to rely on the work of others due to the vast amount of work required in a short period of time. The qualifications and experience required to become an auditor varies vastly throughout the world. Many less developed countries would not require their auditors to be as highly qualified in comparison to the west. Therefore it is difficult to know whether the audit has been critically evaluated or not.

In 1991 Brian Currie suggested that within the UK the accounting profession would split up. The separation of the professional firms could help to improve the creditability of the financial reports.[10] If the auditing firms were to become 'pure', not offering non-auditing services, then this could improve the creditability of the financial statements as investors would feel that the auditors were not influenced.

"The rapid pace of harmonisation of accounting standards is leading to enhanced comparability of financial information worldwide"[11] The enforcement of International Accounting Standards (IAS) in 2005 will harmonise accounting and as a result make it easier for users to compare financial reports from MNCs. Unfortunately the problems of comparability are unlikely to go away, especially when the US offers the option of IAS or US GAAP, although international harmonisation processes may reduce them.

In conclusion when comparing financial statements of MNCs that have subsidiaries it is worth being cautious. There are many areas that can be misleading when making this comparison. The terminology used in financial reports varies from country to country and as a result inaccurate comparison may be made. The accounting standards that need to be complied with by the MNC will vary depending on its domicile and if they are listed on any stock exchanges. As they may have to produce more than one

[6] Choi et al, 2002, pg 209
[7] Choi et al, 2002, pg 209
[8] Gayfer D, 2004, pg 9
[9] Street and Gray
[10] Currie B, 1991
[11] Choi et al, 2002, pg 345

financial report but complying with different standards it is likely that they only comply with the standard rather than try and provide a true and fair view. The translation exchange methods used to consolidate the reports will impact through gains or losses. As different MNCs would use different method of translation it would not allow a fair comparison. It is not possible to know whether the audit has been done accurately and correctly. The credibility of the audit report is still very much open to discussion. The Big Five are not answerable to anyone and they do have a tendency to sign off the audit report when accounting error exists with the financial report. Financial comparison between cross-border and within-border will blur with continuing globalisation and improvements in international accounting.[12]

[12] Choi et al, 2002, pg 345-346

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