MA MANAGEMENT AND INTERNATIONAL BUSINESS

FINANCE ASSIGNMENT

Financial information maybe, in simple terms, understood as information with regards to the functioning of the enterprise and details of its resources. Accounting of financial information is all about providing data that helps to understand the financial position of the organisation, how resources have been used, future changes etc. It is a part of communication. Proper accounting of financial information is essential and it also helps in proper decision-making. Previously financial information used to be communicated only internally. But with the rise in growth and globalisation, there has been communication of financial information externally too. There are several users of financial information. The users of financial reports use the information obtained from financial statements for specific purposes. Investors, competitors, suppliers, government agencies, general public, employees etc. are some of the various user groups.

But there are differences in the way financial information is reported in different countries. The accounting standards are different in different countries. "Accounting of financial information differs in content and application from country to country. In some situations accounting differences lead potentially to inefficiencies, missed opportunities and distortions of economic behaviour." (Walton, Haller and Raffournier, 2003, pg 1). Differences in accounting standards can lead to misinterpretations of the data obtained from it. " Misunderstandings can occur not only because of differences in the method in which the information is sent but also because of differences relating to the perception and interpretation of the information by the receiver." (Walton, Haller and Raffournier, 2003, pg 2). Misunderstood information then becomes obsolete.

Several factors constitute an explanation for the differences in the financial reporting of countries. Some of the important factors are as follows:

1. **LEGAL SYSTEMS**: Reporting of financial information depends to a great extend on the legal system of the country. " Over the years two types of legal systems have developed. The common law system that originated in England is developed from case law. The main characteristic of common law is that it is a law of precedence. The judgements passed in various cases are used for other cases with similar facts."(Walton, Haller and Raffournier, 2003, pg11)." A common law rule seeks to provide an answer to a specific case rather than to formulate a general rule for the future."(Nobes and Parker, 1995,pg 11). "In a common law situation accounting rules are not a part of the law. Company law in the common wealth countries is kept to a minimum. On the other hand, the code law system that originated in Roman law is characterized by a wide set of rules which try to give guidance in all situations. In code law countries the company law is very detailed and accounting standards are often embodied in the company law. Here rules are linked to ideas of justice and morality; they become doctrine. Countries like United States, England, India, and Singapore etc. follow the

common law system; while countries like Japan, Scotland, France, and Germany etc. are code law countries." (Walton, Haller and Raffournier, 2003, pg 25).

2. **FORMATS**: Evident differences maybe noticed in the format adopted by different countries to report financial information. There are several tools like the Profit & Loss Account, the Balance Sheet, and Income Statement etc. that are used to report financial information. For instance, " There are significant differences from country to country in the presentation and content of the income statement as well as in the accounting methods used to measure income statement amounts. The title of the statement, for example, in the United Kingdom (U.K.) it is called the "Group Profit and Loss Account". For example, a typical U.K. balance sheet begins with non current assets, called fixed assets. Current assets are listed next and current liabilities are subtracted to arrive at net current assets, which is added to fixed assets. Long-term debt is then subtracted from this subtotal to arrive at net assets. The net asset total agrees with shareholders' interest, which is reported last." (http://www.people.memphis.edu/~dspice/global.html). "In Singapore and Hong Kong, there are no standardized formats for financial statements, but items in the balance sheet follow an increasing order of liquidity, and profit and loss accounts are rather sparse documents." (Nobes and Parker, 1995, pg 320)
3. **TAX**: As mentioned earlier, there are different users of the financial information. The financial information maybe used to determine the amount of tax to be paid by an organisation. " In countries like Belgium expenses are only tax deductible if they are also mentioned in the Profit and Loss account. As a result financial reporting becomes tax influenced or even tax biased. The link between taxation and financial reporting is often found in those countries that do not have an explicit investor approach in their financial reporting orientation. This relationship can also vary over time. For example, Spain, for a long time ha d a strong link between financial reporting and taxation. But after 1989 the link has become weak and they are moving to be independent." (Alexander et al, 2004, pg 26). " In Korea depreciation generally follows tax rules. In Hong Kong deferred tax is partially accounted for using the liability method, as in the UK. In Taiwan, deferred tax accounting follows US practice.
4. **EARNINGS PER SHARE**: "Earnings per share receive more attention in the United States than in most other countries. In countries that do require EPS disclosures, requirements differ widely. For instance, earnings for the numerator of the EPS calculation are defined in the United States as earnings available for common shareholders, and separate calculations are required for ordinary income and net income when differences exist. In some countries, though, earnings are defined as continuing income from operations only (Norway, e.g.). In the United States, basic and diluted EPS are reported. Other countries have similar requirements but define the two calculations differently from the US (that is, the potentially dilative securities included are different). Some countries require only one of the two calculations. (Japan requires basic only, for example.) Some (Spain, Switzerland, and Germany for instance) require no EPS disclosure at all, but disclosure may be provided anyway." (http://www.people.memphis.edu/~dspice/global.html)
5. **SOURCES OF FINANCE**: "This difference in providers of finance (creditors/insiders) versus (equity/owners) is the key cause for international differences in financial reporting" (Nobes and Parker, 1998). Companies in different countries responded differently to the increased need for finance. In

Germany, France, Italy, Belgium, banks became the major supplier of additional funds. Thus companies relied more on debt financing. On the contrary, in the UK and in the US shareholders provided extra funds, which has given rise to active stock exchanges. (www.svses.cz/akce/ucto04/jindrichovska.pdf). For instance, if debt is the major source of financing, then much of the information can be furnished directly to the lenders, instead of being disclosed to the public at large. Financial reports, as a result, would be creditor- oriented, and their content would primarily address the information needs of the lenders. In case equity capital is the major source of financing, the financial reports would be mainly geared towards equity holders. (Iqbal, 2002 pg 122).

6. **GOODWILL**: " In the United States, goodwill is capitalized and amortized over a period of time no longer than 40 years. Countries such as Australia, Japan, and Sweden also capitalize and amortize goodwill, but the maximum amortization periods vary from 5 to 20 years. Other countries, such as Japan, France, Germany, and Italy permit the immediate write-off of goodwill against current earnings, but as an extraordinary or non-recurring item. The United Kingdom permits the immediate write-off of goodwill against shareholders' equity. Switzerland is the only major industrialized country that allows companies to capitalize goodwill without amortization." (http://www.people.memphis.edu/~dspice/global.html).

These are just some of the important factors, which result in differences in the accounting of financial information. From the above details it can be understood that there are major differences the financial reporting practices of companies in different countries. This causes great difficulty in the preparation, consolidation, auditing and interpretation of financial information. Therefore to tackle this problem, several measures are being taken to standardize accounting.

" There are several bodies that work towards achieving international standardization and IASC- International Accounting Standards Committee is the most important and perhaps the most successful body to achieve this. The IASC founded in 1973 originally comprised of accounting bodies of nine countries: Australia, Canada, Frae, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, the United States and West Germany. The International Accounting Standards board (IASB), the successor body to the IASC, is the international standard setting body now. Formulating and publishing accounting standards that are to be observed in the presentation of financial statements and promoting their worldwide acceptance and observance are the main aims of IASC. The member bodies of IASC agree to support the standards and to use their best endeavours to ensure that their financial statements comply with these standards, ensure that auditors enforce this; and to persuade governments, stock exchanges an other bodies to back the standards (IASC 1983)." (Nobes and Parker, 1995, pg 122) "In 2000 the organisation was reconstructed and cut its formal links with the professional accounting bodies that had created it. It then became a free- standing non- government organisation, funded by voluntary contributions and the sale of publications." (Walton et al, 2003, pg 35)

The ***objectives of IASC*** maybe outlined as follows:((Walton et al, 2003, pg 35)

- To develop a single set of high quality, understandable and enforceable global accounting standards to help users of the information in various capital markets to make economic decisions.
- To promote the use and rigorous application of those standards;
- To work actively with national standards-setters to bring about convergence of national accounting standards and International Financial Reporting Standards (IFRS) to high quality solutions.

"In the early years the IASC was essentially attached to the idea of international harmonization and the creation of body of doctrine which was sufficiently flexible to be acceptable in different countries whose social and economic environments and whose accounting traditions are very diverse. From 1987, IASC with an aim to improvise on the quality of international standards began to focus their development policy on writing standards, which could be used by stock exchange regulators as a common basis for listing worldwide. For the same purpose, IASC entered into an understanding with the International Organisation of Securities Commissions (IOSCO) who wanted to create a situation where a multinational company listed in its home exchange could list anywhere else in the world with a single international package of disclosures. The introduction on the concepts of the benchmark treatment and the allowed alternative treatment enabled the IASC to show its preferences clearly in cases where more than one method was available in a standard. This work resulted, in 1993, in the approval of a set of ten revised standards, which were applicable for the first time for financial periods starting on or after 1 January 1995.

After 1995, in order to accelerate modification of the process IASC entered into a new understanding with IOSCO and produced a redefined set of core standards. Once the standards had been set, the IASB has to refine and extend the standards. Reviewing and improving the existing range of standards was the first amends 12 of the existing standards." (Walton et al, 2003, pg 40)

HARMONIZATION OF FINANCIAL REPORTING

"Harmonization may be understood as a process that is aimed at increasing the compatibility of accounting practices by setting bounds to their degree of variation." (Nobes and Parker, 1995, pg 118). With the growth in international business and globalisation, the financial reports and information of one country are being used in another for several purposes. Therefore is has become necessary that there exists some kind of standards for the preparation of financial reports. "Investors and financial analysts need to be able to understand the financial statements of foreign companies whose shares they might wish to invest in. Statements from different countries must be reliable and comparable.

The advantages of harmonization for multinationals are much more important. It helps in appraising companies for potential takeovers and other aspects like investment appraisal, performance evaluation and other decision-making uses of financial information. International accounting firms also benefit from harmonization as it makes the preparation, consolidation and auditing of financial statements less taxing." (Nobes and Parker, 1995, pg 118).

But there are several obstacles in achieving harmonization. "The size of the present differences between the accounting practices of different countries is the fundamental obstacle. It is practically impossible to set standards that harmonize the financial reporting in every country. The lack of strong professional accountancy bodies in some countries is another hurdle. This means that any body such as the IASC, which seeks to operate through national accountancy bodies, will not be effective in all countries. A further problem is nationalism. This means that some countries may show unwillingness to change their accounting practice towards those of other countries. This also causes difficulty is setting common standards. A recently highlighted difficulty is the effect of economic consequences on accounting standards." (Nobes and Parker, 1995, pg119).

Financial information of companies is of great benefit as they are vast sources of information. Financial reports speak volumes about the accounting procedures and set-up of the company. It is essential that there exist some sort of standard in the preparation and analysis of financial information. This will help to ensure that the inferences made by all the users of the financial reports published are similar. It is essential that there is a commonality in the conclusions and deductions made from the financial reports, as this influences decision- making. Besides IASC there are several other bodies that work for the same cause. These bodies, as mentioned above, have been able to bring about changes in the past situation to some extend. These bodies have to work keeping in mind the fast growing rate of globalisation.

APPENDIX 1:

Some of the other reasons, which result in differences in, the financial reporting of countries maybe outlined as follows.

1. **CLASSIFICATION**: The accounting practices of countries maybe classified on the basis of their political histories. For instance, countries like Hong Kong and Singapore have a UK influence while, Korea and Taiwan are under a ' Continental European influence modified by US influence. In many other areas, practices are similar to US and UK accounting. (Nobes and Parker, 1995, pg 319).

2. **CULTURE DIFFERENCES**: Culture has its own impact on financial reporting. With the fast growth in globalisation, it is becoming increasingly important to be aware and knowledgeable about other cultures to carry our own business effectively and efficiently. "Cultural differences between nations are identified as an important influencing factor on reporting and disclosure behaviour with regard to financial statements." (Alexander et al, 2004, pg 26). Interpretation of financial statements is difficult because customs based on local culture differ from country to country. For instance, the notion of control through direct or indirect majority share ownership and the presence of a holding company or a dominant parent company are foreign concepts to the typical Japanese executive. American practices of consolidation tend to group Japanese corporations in a manner contrary to their normal functioning. (Iqbal, 2002, pg 128)

3. **THE ECONOMIC SYSTEM**: The degree of economic development and the level of technology in a country also influence the complexity of its accounting system. There will be significant difference in the accounting system of an economically developed country with a high level of technology, than a developing country which id primarily agriculture based. Concepts like patents, copyrights etc, have greater significance in those countries which have a high level of technology. (Iqbal, 2002, pg 121)

4. **THE QUALITY OF ACCOUNTING EDUCATION**: The quality of accounting education has a significant impact on the type of accounting system that develops in the country. (Saudagaran, 2001, pg 11). The educational backgrounds of both users and preparers of accounting information have a strong effect on the degree of development and level of sophistication of a country's accounting system. (Iqbal, 2002, pg 126). " Certain countries have a long history of including accounting in their tertiary institutions of higher education. In such countries the students are able to receive a rigorous education in accounting and emerge as well trained individuals who are competent enough to enter the accounting profession. But in some other countries, the quality of accounting education is relatively weak. In these countries, accounting is often considered to be bookkeeping and is regarded as a vocation rather than a profession. As a result, there is a lack of well- qualified accountants and the accounting profession thus suffers. For

example, in Russia there are some local authorities who still require using the accounting system that was developed and practiced during the Soviet-planned economy. These old accounting systems are definitely unable to meet the current accounting requirements. Similarly in some Western firms two sets of accounting books are maintained; one to meet the requirements of the local authorities and the other to meet their own information needs. (Iqbal, 2002, pg 126)

5. **DEPRICIATION**: In the United States, income tax regulations allow firms to use different approaches to computing depreciation in their tax returns and financial statements. Internationally, in a number of countries, such as Japan and Germany, depreciation rates for financial reporting must be the same as those used for income tax purposes. (http://www.people.memphis.edu/~dspice/global.html)

6. **POLITICAL AND ECONOMIC SYSTEM**: Economic stability of a country facilitates the development and continuous improvement of a conceptually sound accounting system. The level to industrialisation and use of technology and the rate of economic growth has great impact on the complexity of the country's accounting system. The political system of a country determines its economic policies and this results in differences in financial reporting. The political and economic systems have a close link. For instance, in the year 1997, South Korea's LG Electronics Inc. cancelled a plan to build consumer electronics plant in Russia due to political instability. Foreign investors avoid investing in countries where there is political instability. Political instability results in deterioration of economic standards.

7. **TERMINOLOGY**: One important factor that causes differences in the reporting of financial information is the JARGONS used in accounting. Terminology differences, even when the same language is used, create difficulty. There are several forms of English language used, particularly for accounting terms. This adds to the difficulty. UK terms and US terms are extensively different. (Alexander et al, 2004, pg 17). When the same term has different definitions in different countries, it poses a greater challenge to the analyst. In the balance sheet significant differences do exist, particularly with respect to terminology. In the U.K., the term "stocks" refers to inventory. A U.S. investor would interpret stocks to mean investments in equity securities of other companies. In the U.S., shareholders' equity is comprised of paid-in capital and retained earnings. In many other countries, shareholders' equity is divided into "capital" and "reserves." For example, in Germany, equity is divided into share capital, capital reserves, and revenue reserves. In India, liabilities whose existence is certain, but whose value must be estimated, are called "provisions" and are listed separately. (http://www.people.memphis.edu/~dspice/global.html). The use of different terms or jargons for a particular concept makes it difficult to analyse the financial information. Unless the information is properly analysed, it is not possible to use it for decision-making.

Some terminology differences between the UK and the US (Iqbal, 2002, pg 250)

UK TERMINOLOGY	**US TERMINOLOGY**
Accounts	Financial statements
Allotted	Issued
Capital redemption reserve	Other additional capital
Debtors	Accounts receivable
Depreciation	Amortization
Financial year	Fiscal year
Hire charges	Rent
Net asset value	Book value
Nominal value	Par value
Profit	Income
Shares in issue	Shares outstanding
Stock	Inventories
Trade debtors	Accounts receivable
Own shares	Treasury stock
Merger accounting	Pooling of interests accounting
Loan capital	Long term debt

APPENDIX 2:

Some of the amendments made by the International Accounting Standards Board are as follows (Walton et al, 2003, pg 46 - 59)

1. ***IAS 16*** defines tangible fixed as those which are:
    - Held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes;
    - Expected to be used during more than one accounting period.
2. ***IAS 38*** – Intangible fixed assets are valued:
    - Either at their cost as reduced by depreciation and any necessary write- downs;
    - Or at their fair value, provided that this can be reliably measured. Reliable measurement depends upon there having recently been a relevant transaction, or there being an active secondary market for this type of asset.
3. ***IAS 2***- The standard considers inventories to be:
    - Assets held for sale or in the process of production for such sale in the ordinary course of business;
    - Materials and supplies to be consumed in the production process or in the rendering of services.
4. ***IAS 7***- Cash Flow Statements

    The cash flow statement should show inflows and outflows relating to:
    - Operating activities;
    - Investing activities;
    - Inancing activities.
5. ***IAS 20***- Accounting Government Grants

    The standard distinguishes between two types of government subsidy:
    - Asset grants, whose primary condition is that the enterprise should purchase, construct or otherwise acquire long- term assets;
    - Other grants, known as income grants.
6. ***IAS 18***- Revenue

    Two conditions are necessary for revenue to be recognized:
    - That it is probable that the enterprise will gain economic benefits from the transaction;
    - The amount can be measured reliably.

APPENDIX 3:

Examples that indicate the need for harmonization: (Nobes and Parker, 1995, pg 119).

1) For 1993, Daimler- Benz, a German company, disclosed an income of DM 615m, but this would have been expressed as a loss of DM 1,839m according to US rules.

2) The Norwegian company, Norsk Hydro, reports a 1992 income of NOK 167m but shows that it would be NOK 1763m according to US rules i.e. 956per cent higher.

3) The shareholders equity of the News Corporation, an Australian company, was A$11699 according to Australian rules but A$4232 according to US rules.

The sources of current pressure for harmonization are (Saudagaran, 2001, pg 34)

1) **INVESTORS:** The sudden upsurge in cross- border securities listing has increased the number of investors who make use of the financial information of foreign countries. Since the accounting standards are different in every country, comparison of the financial statements id difficult. Moreover, they cannot be considered as a reliable source on the basis of which decisions can be taken. Investors and financial analysts favour harmonization because they believe that it will help lower the cost of investing abroad and enhance their ability to make effective investment decisions across borders.

2) **MULTINATIONAL COMPANIES:** As capital, product and labour markets are becoming increasingly global, most large companies find themselves having to diversify geographically to effectively compete with their competitors. Multinational companies account for a large percentage of the global trade. The efforts of multinational companies to tap foreign investors and to attract leading preparers of financial statements will be adversely affected by the differences in the financial reporting. Reduced cost of preparing consolidated financial statements, ease in monitoring subsidiaries abroad, more meaningful managerial accounting reports and more relevant performance evaluation methods are the additional advantages of harmonization to multinational companies.

3) **DEVELOPING COUNTRIES:** Most developing countries implement accounting standards that inspire confidence of the foreign investors, in

order to attract them. International accounting standards provide a low-cost option for developing countries that do not have the resources to develop an extensive set of domestic accounting standards. Moreover, adopting a harmonizes set of international accounting standards also saves developing countries from having to provide expensive reconciliation to the GAAP of foreign providers of capital.

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