International Accounting

Chapter 6

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International business accounting issues

- **Dealing with foreign companies presents some unique problems**
  1. there is the possibility of exchange gains and losses between the time an order is given or received and the time of payment
  2. it is difficult to obtain international credit information and evaluating the company's liquidity and solvency from its financial statements may be difficult because of the use of a different language and/or different accounting principles.
  3. as a company's foreign trade increases, it may be necessary to create an international division, additionally, it may become necessary to develop international accounting skill.
  4. the company may decide to attempt to raise capital in foreign markets.

The development of accounting system

- The level of development of a country's accounting system impacted by **environmental forces** such as:
  - the overall level of education
  - the type of political system
  - the type of legal system
  - extent of economic development
**Level of Education**

- there is a direct correlation *between* the level of education obtained by a country's *and* the development of the financial accounting reporting practices in that country.

- the characteristics composing these environmental factors include:
  1. the degree of literacy in a country.
  2. the percentage of the population that have completed grade school, high school and college.
  3. the orientation of the educational system.
  4. the appropriateness of the educational system to the country's economic and social needs.

- counties with better educated population are related with more advanced financial accounting systems.

**political system**

- the type of political system can influences the development of accounting standards and procedures.

- accounting system in a country with a centrally controlled economy will be different from an accounting system in a market-oriented.

**legal system**

- the extent to which a country's laws determine accounting practices has impact on the strength of that country's accounting profession.
Economic development

- the level of a country's economic development influences both the development and application of its accounting report practices.

- countries with low levels of economic development will have relatively less need for a sophisticated accounting system than countries with high levels of economic development.

preparation of financial statements for foreign users

- a company issuing financial reports to users in foreign countries may take one of several different approaches in the preparation of its financial statements:
  1. send the same set of financial statements to all users.
  2. translate the financial statements set to foreign users into the language of the foreign nations users.
  3. translate the financial statements sent to foreign users into the foreign nation's language and currency.
  4. prepare two sets of financial statements, one using the home country language, currency, and accounting principles, the second using the language, currency, and accounting principles of the foreign country's users.
  5. prepare one set of financial statements based on worldwide accepted accounting principles.

the international accounting standards committee

- the international accounting standards committee LASC was formed in 1973 to develop worldwide accounting standards. It is independent private sector body, whose objective is to achieve uniformity in the accounting principles that are used for worldwide financial reporting.
• the standard – setting process of the LASC is similar to that followed by the FASB and included the following steps:
  1. the Board sets up a Steering Committee.
  2. the Steering Committee identifies and reviews all of the accounting issues associated with the topic.
  3. the Board prepares and submits comments to the Steering Committee on the Point Outline.
  4. the Steering Committee reviews the comments on the Draft Statement and prepares a final statement of principles that is submitted to the Board.
  5. the Steering Committee prepares a preliminary Exposure Draft for approval by the Board.
  6. the Steering Committee reviews the comments and prepares a draft international Accounting Standard for review by the Board.

• in contrast to standards issued by the FASB, international accounting standards LAsSs sometimes permit two accounting treatments for accounting transactions and events.

• an additional difference in the standard – setting process is that the LASC currently does not issue interpretations of its standards and its prohibits LASC staff from giving advice on the meaning of its standards because of resources constraints.

the users of international accounting standards

• the LASC has noted that its standards are used in a variety of ways:
  1. as national requirements.
  2. as the basis for some or all national requirements.
  3. as an international benchmark for those countries which develop their own requirements.
  4. by regulatory authorities for domestic and foreign companies.
  5. by companies themselves.
in united states, the two bodies directly concerned with standard setting, the FASB and the SEC are not members of the LASC

Current issues

the LASC has recently entered into a partnership with the IOSCO to work together to encourage stock exchanges throughout the world to accept financial statements prepared under LASC standards.

the following issues will need to be addressed by standard-setting bodies:

1. can international accounting standards be set voluntarily by organizations representing a broad set of independent nations?
2. what is the impact on standard setting of differing economies and social settings in various countries?
3. can lessons be learned from other international world bodies with independent members having experience in bringing conflicting national laws into harmony?
4. have the major political and economic questions involved in standard setting been examined adequately?
5. how can the roadblock of national limitations be eliminated so that international accounting standards can be enforced?

framework for the preparation and presentation of financial statements

in 1989, the LASC issued its conceptual frame work titled "framework for the preparation and presentation of financial statements"

the LASC indicated that the purpose of this pronouncement is to set out the concepts that underlie the preparation and presentation financial statements for external users by:

1. assisting the LASC in developing future accounting standards.
2. promoting harmonization of accounting standard.
3. assisting national standards setters.
4. assisting preparers in applying international standards.
5. assisting auditors in forming an opinion as to whether financial statements conform to international standards.
6. assisting users interpreting financial statements prepared in conformity with international standards.
7. providing interested parties with information about the LASC's approach to the formation of international accounting standards.

- **the framework specific:**
  1. the objective of financial statements.
  2. the qualitative characteristics that determine the usefulness of information in financial statements.
  3. the definition, recognition, and measurement of the elements from which financial are constructed.
  4. the concepts of capital and capital maintenance.

- **the framework indicates:**
  - companies prepare general – purpose financial statements that are direct toward the information needs of a wide variety of users including: *investors, employee, lenders, suppliers and other trade creditors, customers, governments, and the general public*.
  - information needs of these users cannot be met only by the presentation of financial statements, there are needs that are common to all users.
  - since investors are the providers of risk capital to the enterprise, the preparation of financial statements that meet their needs will also satisfy most of the needs of other users.
The objective of financial statements

- the framework indicates that the objective of financial statements is to provide information about the financial position, performance, and changes in financial position of an enterprise that is useful to a wide range of users making economic decision.

- In its discussion of general – purpose financial statements, the framework indicated:
  1. users require an evaluation of the ability of an enterprise to generate cash and certainty of this generation.
  2. the financial position of an enterprise is effected by the economic resources its controls, its financial structure, its liquidity and solvency, and its capacity to adapt to change in its environment.
  3. information on profitability is required to assess changes in the economic resources an enterprise controls in the future.
  4. information on the financial position of an enterprise is useful in assessing its investing, financing, and operating activities.
  5. information about financial position is contained in the balance sheet and information about performance is contained in an income statement.

- the framework also indicated that two underling assumptions for the preparation of financial statements were the:
  - accrual basis
  - going concern

qualitative characteristics

- the framework describes qualitative characteristics as the attributes that make the information provided in financial statements useful.
• the following four principles qualitative were defined:
  ▪ understandability
  ▪ relevance
  ▪ reliability
  ▪ comparability

• we discussed in (chapter 1)

**The Elements of financial statements**

• the elements directly related to the measurement of financial position in the balance sheet are:
  ▪ **asset** – a resource controlled by an enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
  ▪ **liability** – a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefit.
  ▪ **equity** - the residual interest in the assets of enterprise after deducting all its liability.

• the elements directly related to the measurement of performance in the income end expenses:
  ▪ **income** – increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or the decrease in liabilities that result in increase in equity other than those relating to contributions from equity participants.
  ▪ **expenses** - decrease in economic benefits during the accounting period in the form of inflows or depletions of assets or the incurrence of liabilities that result in decrease in equity other than those relating to contributions from equity participants.
the framework went on to indicate that recognition is the process of incorporating in the financial statements an item that meets the definition of an element and satisfies the following recognition criteria:
1. it is probable that any future economic benefit associated with the item will flow to or from the enterprise.
2. the item has a cost or value that can be measured with reliability.

- variety of measurement bases are to employed in financial statements including:
  - historical cost
  - current cost
  - realizable value
  - present value

**concepts of capital and capital maintenances:**

- **capital is defined as** synonymous with the net assets or equity of the enterprise.

- the selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statement.

- result the following concepts of capital maintenance may be used:
  - financial capital maintenance
  - physical capital maintenance

- (we discussed in chapter 3)
The financial statement impact of international accounting

- Gray suggested that a first step to determining the qualitative impact on earnings arising from the use of different accounting principles is the use of an index of conservatism which is based on U.S GAAP follows:

\[ \text{Index of Conservatism} = \frac{(U.S. \text{ GAAP Earnings} - \text{Foreign Country GAAP Earnings})}{\text{U.S GAAP Earnings}} \]

The financial statement impact of international accounting standard

- The FASB recently undertook a project whose objective was to analyze the financial statement impact of the similarities and difference between LASC standards and U.S GAAP.

- Each LASC analyzed in attempt to:
  1- Identify similarities and differences of the LASC standard to U.S GAAP.
  2- Assess the impact of these similarities and differences their relative significance.
  3- Include example wherever possible.

Security analysts

1- Which of the differences would be of most concern to an analyst (a) in analyzing a company that used the LASC standard and (b) in comparing two companies, one using the LASC and the other using U.S GAAP?
2- What is the level of concern about the difference – low, middling, high?
3- What alternative sources of information might an analyst use to assess differences between standards?
4- Are there changes in U.S GAAP which might eliminate or narrow difference? should the FASB consider adopting the LASC standard to replace existing GAAP?