

Dominican University of California  
International Accounting  
Final Examination  
James E. Salter

**Part A. Case Analysis Opole Electric**

**Question 1. Perform financial ratio analysis from the host country perspective without translation. Financial analysis should include return on investment, return on net asset, current ratio, quick ratio, and debt ratio.**

Ratio	Calculations	1991(Zlotys in thousands)	
<b>Current Ratio</b>	<u>current assets</u>	<b>150,412,000</b>	<b>2.154992</b>
	<u>current liabilities</u>	<b>69,797,000</b>	
<b>Debt ratio</b>	<u>Total Debt</u>	<b>69,797,000</b>	<b>0.268123</b>
	<u>total assets</u>	<b>260,317,000</b>	
<b>Return on Net Assets</b>	<u>earning after tax</u>	<b>11,000,000</b>	<b>0.061275</b>
	<u>(fixed assets + net working capital)</u>	<b>179,520,000</b>	
<b>Return on investments</b>	<u>earning after tax</u>	<b>11,000,000</b>	<b>0.057737</b>
	<u>shareholders equity</u>	<b>190,520,000</b>	
<b>Quick ratio</b>	<u>current assets- inventory pre paid expenses</u>	<b>88,710,000</b>	<b>1.270972</b>
	<u>current liabilities</u>	<b>69,797,000</b>	

**Question 2. Perform the financial ratio analysis as in Q1 from Edward Bobinski's home country perspective or after translation. Comment on the correctness of using standard financial analysis of return on investment in this case?**

Ratio Analysis				
	Formula	Figures	Total	%
Return on Investment	<u>Net income</u>	<b>-2051.2652</b>	<b>-0.084500105</b>	<b>8.45</b>
	<u>Total Assets</u>	<b>24275.29762</b>		

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<b>Return on Net Assets</b>	<u><b>Net Income</b></u>	<u><b>-2051.2652</b></u>	<b>-0.106172249</b>	<b>10.6</b>
	<b>Assets - Liabilities</b>	<b>19320.16343</b>		
<b>Current Ratio</b>	<u><b>Current Asset</b></u>	<u><b>13794.0476</b></u>	<b>2.656671551</b>	<b>2.67:1</b>
	<b>Current Liabilities</b>	<b>5192.2292</b>		
<b>Quick Ratio</b>	<u><b>Current Assets-Inventories and prepaid expenses</b></u>	<u><b>6212.7976</b></u>	<b>1.196556885</b>	<b>1.19:1</b>
	<b>Current Liabilities</b>	<b>5192.2292</b>		
<b>Debt Ratio</b>	<u><b>Debt</b></u>	<u><b>5192.2292</b></u>	<b>0.213889415</b>	<b>21</b>
	<b>Total Assets</b>	<b>24275.29762</b>		

The standard financial model for return on investment raises many questions. The first question is to references time. This is due to the ratio being calculated by dividing the average return by the average investment. The standard analysis does not take into account the issues most pertaining to managers' decisions. The standard ROI looks at the changes in outputs relating to investment. However, it does not take into account risk reduction, overall productivity, and net increases in dollar sales. Standard financial models show the effects caused by delays in product release on costs and revenues. Nevertheless, they require the quantification of risk factors and clear estimates of productivity changes. These factors are the most difficult to determine.

As Robbins and Stobaugh noted in a study in 1973, the most utilized measure of performance for all subsidiaries was ROI. However, where intra-corporate transfers are significant and are not at arm's length prices, the ROI income numerator is highly arbitrary and in one sense fictitious. A subsidiary manager whose evaluation is based on ROI may choose to borrow heavily in the local currency. This in turn affects the borrowing capacity of the entire firm and potentially the price of its stock and possibly subjecting the parent consolidated financial statements to significant foreign currency losses if the borrowings are in hard currencies. ROI is not appropriate for some foreign operations, such as subsidiaries producing only for other subsidiaries, sales subsidiaries buying all their products from other subsidiaries, or subsidiaries striving to break into highly competitive, low margin markets.

It is noted earlier that comparing ROI's is the primary method of evaluating both individual operations and managers on a standardized basis. The need for standardization brings us back to one method performance evaluation that can meet most criteria without unnecessary limitations, the evaluation of performance with plan.

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<b>Balance Sheet at December 31, 1991</b>			
	<b>Zlotys</b>	<b>Exchange rate</b>	<b>U.S. \$</b>
Cash	4100000	13440	305.0595238
Accounts Receivable	79400000	13440	5907.738095
Inventories	66912000	13440	4978.571429
<b>Balance Sheet as at December 31, 1991</b>			
	<b>Zlotys</b>	<b>Exchange rate</b>	<b>U.S. \$</b>
Cash	4100000	13440	305.0595238
Accounts Receivable	79400000	13440	5907.738095
Inventories	66912000	13440	4978.571429
Plant and Equipment	129300000	8400	15392.85714
Depreciation accumulated	-19395000	8400	-2308.92857
<b>Total Assets</b>	<b>260317000</b>		<b>24275.29762</b>
Payables to suppliers	50677000	13440	3770.610119
Payables to bank: Poland	14000000	13440	1041.666667
Payables to bank: U.K	5120000	22848/pound and 170/dollar	142.8574
Share Capital: State Owned	116809000	8400	13905.83333
Share Capital: Private	4651000	8400	553.6904762
Profits Reinvested	69060000		4860.639624
<b>Total Equities</b>	<b>260317000</b>		<b>24275.29762</b>
<b>Statement of Earnings for Year Ended December</b>			
		<b>Exchange Rate</b>	<b>1991</b>
Revenues from sales within Poland	99196000	10920	9083.882784
Revenues from sales to	72181000	10920	6609.981685

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<b>Czechoslovakia</b>			
<b>Revenues from Sales to Western Europe</b>	<b>48271000</b>	<b>10920</b>	<b>4420.421245</b>
<b>Total Revenues</b>	<b>219648000</b>		<b>20114.28571</b>
<b>Cost of Sales see sheet 2</b>	<b>147098000</b>		<b>16221.06227</b>
<b>Gross Margin</b>	<b>72550000</b>		<b>3893.223444</b>
<b>Less Expenses</b>			
<b>Expenses for City Services</b>	<b>12147000</b>	<b>10920</b>	<b>1112.362637</b>
<b>U.K. debt translated loss</b>	<b>1920000</b>		<b>238.095</b>
<b>Selling expenses</b>	<b>20413000</b>	<b>10920</b>	<b>1869.322344</b>
<b>Administrative expenses</b>	<b>27070000</b>	<b>10920</b>	<b>2478.937729</b>
<b>Translation gain or loss</b>			<b>245.7709</b>
<b>Total Expenses</b>	<b>61550000</b>		<b>5944.488611</b>
<b>Profit for the Year</b>	<b>11000000</b>		<b>-2051.2652</b>
<b>Retained Earnings 31/12/90</b>	<b>58060000</b>	<b>8400</b>	<b>6911.904762</b>
<b>Retained Earnings 12/31/91</b>	<b>69060000</b>		<b>4860.639624</b>

<b>Cost of Sales</b>			
	<b>Slotys</b>	<b>FX rate</b>	<b>\$</b>
<b>Beginning Inventories Jan 1 1991</b>	<b>58300000</b>	<b>8400</b>	<b>6940.47619</b>
<b>Purchases</b>	<b>155710000</b>	<b>10920</b>	<b>14259.15751</b>
<b>Inventories Dec 31 1991</b>	<b>-66912000</b>	<b>13440</b>	<b>-4978.571429</b>
<b>Cost of Sales</b>	<b>147098000</b>		<b>16221.06227</b>

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Budgeted Data: Total Zloty Cost Total Revenue and Costs			
Normal Units Produced and Sold			
Starting motors	240000	528000	1.2672E+11
Alternators	160000	422400	67584000000
			1.94304E+11
<b>Products cost per unit</b>			
Starting motors			
Direct materials		260000	
Direct labor (9 hours)		79200	
<b>Total per unit cost</b>		339200	
<b>Total Cost</b>			81408000000
Alternators			
Direct materials		210000	
Direct labor		77000	
<b>Total per unit cost</b>		287000	
<b>Total Cost</b>			45920000000
<b>Total Costs</b>			1.27328E+11
<b>Total Net Worth</b>			66976000000
<b>ROI</b>			1.526011561
Actual Data Total Zloty Cost \$			
Starting motors sold	209300	528000	1.1051E+11
Alternators sold	146500	422400	61881600000
<b>Total Revenue</b>			1.72392E+11
<b>Product Cost</b>			
Starting Motors	212000		59360000
Alternators	141000		32430000
<b>Total Cost</b>			91790000
<b>Actual direct labor hrs</b>			
Starting motors (9)			30240000
Alternators (7)			11340000
<b>Total Cost</b>			41580000

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Total Cost			133370000
Net Worth			1.72259E+11
ROI			1291.584539
<b>Actual Data Translation</b>			
	<b>Total Revenues</b>	<b>FX Rate</b>	<b>Total Revenue</b>
	<b>in Zlytos</b>		
Starting motors sold	1.1051E+11		
Alternators sold	61881600000		
Total Revenue	1.72392E+11	13440	12826785.71
Product Cost			
Starting Motors	59360000		
Alternators	32430000		
Total Cost	91790000	13440	6829.613095
Actual direct labor hrs			
Starting motors (9)	30240000		
Alternators (7)	11340000		
Total Cost	41580000	13440	3093.75
Total Cost			9923.363095
Net Worth			12816862.35
ROI			1291.584539
<b>Budget Data/Translation</b>			
<b>Starting Motors Sold</b>	<b>Total Revenues</b>	<b>FX Rate</b>	<b>Total Revenue</b>
Alternators sold	1.2672E+11		
Total Revenue	67584000000		
	1.94304E+11	10920	17793406.59
Product cost per unit			
starting motors			
direct materials			
direct labor			
Total per unit cost			
total cost motors			
Alternators	81408000000	10920	7454945.055
Direct material			
direct labor			
Total cost alternators			
total cost	45920000000	10920	4205128.205

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	<b>1.27328E+11</b>	<b>10920</b>	<b>11660073.26</b>
<b>Net Worth</b>			
<b>ROI</b>	<b>66976000000</b>		
	<b>1.526011561</b>		

**Question 3. What exchange rate is best when comparing actual costs with budgeted costs? Can measurement be held responsible for exchange rate movements on purchase prices, labor costs, and sales prices? What factors should be considered when evaluating Opole's manufacturing performance? What factors should be considered in making the investment decisions?**

While countries experience periods of price stability the historical cost accounting method make available for indication of value providing a basis for judging the performance and efficiency of management. In the case of Opole Electra they have experienced inflation rates of around 60% a year. Under historical costs it does not provide adequate reflection of inflation and or other changes in the financial arena. It is important for Opole Electra to examine the companies performance of should be compared by simply comparing the different performance of quarters. Another methodology that can be used is the current values that price at which items could be purchased today (replacement values).

The major drawback to historical costs is that it is unrelated during an inflationary period. As we will further discuss further in Part C, inflation increases the exchange of the home country currency decreases in relation to another foreign currency. If the company uses the historical exchange rate when comparing actual costs with budgeted costs. The budgeted costs will report higher return on investments. Nevertheless, the actual costs using the current exchange rate reports the actual return on investments since it takes into account the decrease in value of home currency. Back in inflation, during these periods there is an large amount of money floating around that can be used to purchases very little commodities. The direct result is that price levels will increase, the prices of purchases will also increase, sales, and also labor costs will go up.

The areas to consider when making investment decisions is to reach or maximize profits; whereas, their marginal revenue is greater than your marginal cost. Meaning that you want to maximize overall profits for the firm. It is the managers responsibility to makes decision to accomplish these objectives. The budget should reflect projections for future results and they should take all relevant factors into account when establishing the budget amount. The company has experienced very long period of inflation. The important part for management would be to foresee reoccurring inflation and take that into account for the following period. Consequently, the budgeted costs should include higher purchase costs, sales costs, and labor prices.

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It is vital for management to be responsible for the movement and value between exchange rates. In this case, the company did not anticipate exchange rate movements and thus did not increase sales price to combat the exchange rate losses. The company experienced movements that totally increased the company's total costs. Therefore, poorly affecting the performance of the company. Due to the establishment of responsibility by the manager for the overall performance they should have increased the sales price in reduce the change in price effect. It is essential that the company monitor the adjustment of the sales price closely due to the fact that mishandling the price may cause overall profits to decrease.

In order to properly evaluate and consider the level of investments, decisions should include but not be limited to the following areas:

- The management of debt ratios to access and determine the proper level of debt financing and the implications.
- Monitor and calculate the relevant market value ratios. These ratios will provide information into the level of present and past performance to forecast future earnings.
- Next, it is important to calculate the profitability ratio to proper evaluate the combined effects of liquidity, debt, and asset management.
- For asset management ratios the manager would use them to monitor the effectiveness of the companies is managing its assets.
- Next the company should calculate liquidity ratios to determine the level of cash on hand for debts.
- Finally, the firm should always conduct profitability ratios that encompass many of the above areas. Including the combing effects of assets, management, debt, liquidity, and operations.

The above bulleted list should be the primary decisions to be made when making investment decisions. However, these areas need to be developed with the goal in mind to do a strategic analysis. This analysis should include a SWOT analysis focusing on the opportunities to expand operations domestically and internationally. Within this analysis the company will evaluate the companies' availability of supplies and other resources. The company should also consider areas that would provide unwanted risk, this may be in inflation with no price level adjustments, from competition, foreign exchanges rates, foreign currencies, and interest rates.

A further area that needs to be considered when evaluating Opele's manufacturing performance is to monitor the purchase price variance to evaluate the expected and the actual costs used to determine an acceptable level of variance. Second, as I stated earlier it is important to monitor the impact of inflation on wages and the purchase price. Third, the company should evaluate the expected and actual costs to establish how well the company is reaching expected rates for specific labor and machine production areas.

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Therefore, this efficiency analysis is basic purpose it what it sounds like, the company will monitor the efficiency of operations. This should also be done within the company as to establish the economic and industry conditions to be the benchmarked date for comparison. Final, it is crucial to monitor the accounting valuation differences. After completion of these suggested methods for evaluating performance managers will be able to efficiency evaluate and forecast the industries movements and most important the companies performance in relation to the economic conditions.

A final issue to examine is to understand the management objectives to achieve profit maximization whilst providing a work experience interrelated to the maximizing profits. Additional, factors to be considered when making investment decisions are summarized below:

- Geographic location reaching a desired market potential.
- Level of skilled labor (related to location).
- The accounting standards to be considered in decision making.
- The overall quality of output.
- Opole Electric has little to no marketing experience.
- Taxation regulations and or legal requirements that may hinder profit maximization.
- The company should possible consider being a LLC type corporation to reduce the level of risk.
- Level of auditing standards, experience, and knowledge.

**Part B: Calculations**

**Question 1. Assume the following exchange rates between the H.K. dollar to \$1.00 U.S. dollar.**

<b>Spot</b>	<b>March 1</b>	<b>\$7.7782</b>
<b>60 Day Forward</b>	<b>March 1</b>	<b>\$7.7844</b>
<b>Spot</b>	<b>March 31</b>	<b>\$7.8002</b>
<b>Spot</b>	<b>April 30</b>	<b>\$7.7923</b>

**On March 1, a Hong Kong manufacturer enters into a commitment to sell toys to a U.S. importer for H.K. \$2,000,000. The goods are to be delivered and paid for on April 30. Assume a forward contract is entered into on March 1, what should be the journal entries for the U.S. importer on March 1, March 31, and April 30<sup>th</sup>.**

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Date	Account	Debit	Credit
1-March	Purchases	257128.898	
	Account Payable		257128.898
	To record the	Purchase at	Spot rate
	Forward contract	256924.105	
	Bank		256924.105
<b>To record commitment</b>		<b>To deliver \$ To the Bank</b>	
<b>At forward rate of 7.7844</b>			
31-March	Foreign exchange loss	725.216	
	Accounts payable		725.216
<b>Foreign Exchange Adjustment do to Spot Rate</b>			
30-April	Bank	256924.105	
	Cash		256924.105
	To pay FX at forward rate	7.7844	
	Foreign currency	256663.63	
	FX loss	260.475	
	Forward contract		256924.105
	Accounts payable	257128	
	Foreign Gain		465.268
	Foreign currency		256663.63

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1. What is Parent's (unconsolidated) net income?

Parent (unconsolidated) Net Income	Parent
Revenues	5000
Rent income	0
Dividend income	270
Less Expenses	<u>-4180</u>
Net Income	1090

2. What is Subsidiary's net income?

Subsidiary's net income	Subsidiary
Revenues	3510
Rent income	220
Dividend income	0
Less Expenses	<u>-2950</u>
Net Income	780

3. What is the consolidated profit on the inventory that Parent originally sold subsidiary?

Consolidated profit on the	
Inventory that Parent sold to subsidiary.	
See Note D	
Sale by subsidiary of inventory to 3rd party	3050
Less Cost of inventory	<u>-1600</u>
Consolidated profit on sale	1450

4. What are the amounts of the following, on a consolidated basis?

- a) Cash
- b) Receivables
- c) Accounts Payable
- d) Revenues
- e) Expenses
- f) Dividend income

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- g) Rent income
- h) Retained earnings

Amounts of the following, on a consolidated basis.					
	Parent	Subsidiary	Adjustments		Consolidated
			Debit	Credit	
a. Cash	200	70			270
b. Receivables	400	190		85	505
c. Accounts payable	265	100	85		280
d. Revenues	5000	3510	2100		6410
e. Expenses	4180	2950		220	4810
				2100	
f. Dividend income	270	0	270		0
g. Rent income	0	220	220		0
h. Retained earnings	810	670		270	1750

5. If, instead of consolidated financial statements, Parent presented only its unconsolidated statements, what kind of transactions could engage in with subsidiary to improve the appearances of its own profitability?

The parent company could engage in intra-company transactions with their subsidiary.

**Question 3. Egalite S.A. (A)**

1. Assume that Egalite is an autonomous subsidiary. Translate Egalite's trial balance into U.S. dollars using the modified current rate method required by FASB Statement 52?

2. What is Egalite's net income expressed in French francs?

See below, the net income in French francs is 33000.



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Question 4. N.V. Cirts

1. Prepare a secondary set of financial statements conforming to U.S. GAAP?

N.V. Cirts		
Financial Statements as per U.S. GAAP	\$	\$
<b>Balance Sheet</b>		
<b>Fixed Assets</b>		<b>124000</b>
<b>Current Assets</b>		
Cash	26000	
Inventory	<u>53000</u>	79000
<b>Total Assets</b>		<b>203000</b>
<b>Liabilities and Stockholders Equity</b>		
Payables and Reserves	32000	
Common Stock	40000	
Retained Earnings	<u>131000</u>	
<b>Total Liabilities &amp; Stockholders Equity</b>		<b><u>203000</u></b>
<b>Income statement</b>		
Sales		470000
Cost of Goods Sold		<u>-240000</u>
<b>Gross Profit</b>		<b>230000</b>
Salaries	69000	
Depreciation	18000	
Tax expenses	42000	
Other expenses	21000	
<b>Total Expense</b>		<b><u>150000</u></b>
<b>Net Income</b>		<b><u>80000</u></b>

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2. Compare Cirts's financial statements prepared on the basis of Dutch GAAP with the financial statements conforming to U.S. GAAP (compare the statements given to you with those you prepared for question 1). Which set makes Cirts appear to be healthier financially? Which set best reflects economic reality? Why?

The financial statements prepared under the US GAAP look as if it is healthier than the statements prepared by N.V. Cirts. Whereas, net income is calculated to be 80,000 dollars under the U.S. GAAP compared to only 38,000 dollars in N.V. Cirts' income statement. Conversely, the financial statement prepared by N.V. Cirts better reflects reality because inventory, fixed assets and expenses of goods sold and depreciation are stated at current values, taking into account inflation with charges in value over time. It is recommended that firms evaluate assets quarterly to reveal the market value.

**Part C: Essay**

**Question 1: How do price changes and inflation affect the financial position and performance of a corporation? What operational problems does inflation create for managers?**

Inflation is a worldwide phenomenon with varying impact in different countries. In recent years, countries, such as Argentina, Brazil, Chile, Israel, Mexico, and Russia have been among the worst sufferers of hyperinflationary conditions. Under inflationary conditions, where prices are continually changing, traditional historical cost accounting becomes defective and misleading as a basis for decision making. But, first, we must define some terms. Inflation can be defined as an increase in the level of prices of goods and services in the economy. It is typically measured by examining a basket of goods and services (eg. by the Consumer Price Index). Since inflation skyrocketed into double digits in the late 1970s, central bankers around the world have focused on one main goal to achieve price stability. To control fast-rising prices, policymakers in the U.S., Britain, Germany, and Japan were prepared to absorb years of slow growth, and if necessary, deep recessions.

Inflation is an inclination of rising prices caused by demand exceeding supply, and it is a persistent problem in many of the economies. To look at inflation it is important to consider what kind of inflation they will be. Despite strong growth, core inflation ran at only a 1.8% annual rate over the last six months. Service inflation is falling in housing, education, and other areas of historically persistent price increases. Goods prices, excluding food and energy, have actually declined since mid-1997. Moreover, Greenspan and other economists now believe that the official CPI overstates inflation by at least a

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percentage point. That means the U.S. is actually approaching what many forecasters did not think possible: the zero-inflation economy.<sup>1</sup>

The benefits of zero inflation are already rippling through the entire economy. In a low-inflation environment, corporations are better able to plan and make decisions, since they no longer face the prospect of sudden inflationary shocks. Long-term interest rates fall as investors become more willing to lock up money for years because they are less fearful that the value of their investments will erode. And with inflation under control, the Fed can allow expansions to run longer, avoiding the boom-bust cycles which have led to recessions in the past. That means the Fed now has room to cut rates if economic growth should slow because of the Asian crisis or for some other reason.

That's the good news. But a zero-inflation economy brings new dangers as well—specifically, the possibility of deflation. Deflation, or falling prices, can be a positive sign if it is caused by rising productivity. But in his speech, Greenspan spoke of the damage that could be done by runaway deflation which pulls down the price of assets such as stocks and real estate. In addition, a smooth macroeconomic ride does not protect some companies from rude shocks. Price stability means that the cost of raw materials and other inputs won't rise very much. But, at the same time, companies find it difficult to command more for their output. And in industries with global overcapacity, such as steel and autos, companies could see earnings hit hard by falling prices.<sup>2</sup>

Price changes of inflation on the financial position and performance of a corporation can result in inefficient operating decisions by managers who do not understand its impact. In term of financial position, financial assets such as cash lose value during inflation because their purchasing power diminishes. For example, if a business holds financial assets such as cash during a period when inflation rises 10 percent, that cash has 10 percent less purchasing power at the end of the period than at the beginning. Conversely, holding financial liabilities is beneficial because the business will pay its obligation in the future with cash that has lost some of its purchasing power. The warning here is that financial liabilities, such as short term and long term bank loans, often carry very high interest rates in inflationary economies.<sup>3</sup>

The effect of inflation on non-monetary assets is reflected in both the income statement and the balance sheet. During a period of rising prices, current sales revenues are matched against inventory that may not have been purchased several months earlier and against depreciation computed on the historical cost of property, plant, and equipment that may have been purchased several years ago, despite the fact that replacing inventory and fixed assets has become more expensive. These income statement and balance sheets

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<sup>1</sup> [www.businessweek.com](http://www.businessweek.com)

<sup>2</sup> [www.businessweek.com](http://www.businessweek.com)

<sup>3</sup> Gray, Sidney J., Radebaugh, Lee H., *International Accounting and Multinational Enterprises*, Fifth Ed., Page 290, 2002.

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effects could lead the corporation into liquidity problems as the cash generated from revenues is consumed by the ever-increasing replacement cost of assets. The overstatement of income that results from matching old costs with new revenues could lead to demands from shareholders for increased dividends and from employees for higher wages, even though the corporation is watching its cash diminish.<sup>4</sup>

There's also the concern that companies will face a profit squeeze if they must pay more to keep workers in a tight job market, but can't pass on the cost in price increases. Despite the low unemployment rate, however, that hasn't happened yet. One reason is that a surge of college-educated workers—the crucial resource for many companies—has entered the workforce over the last two years, relieving some pressure on hiring. From March, 1995, to March, 1997, the number of people over 25 with college degrees rose by 6.4%, far outpacing the 4% increase in the number of jobs.<sup>5</sup>

The companies that are most in danger of seeing price stability turn ugly—to serious deflation—are those in commodity businesses. The most outstanding example is oil. Wall Street analysts are now calling for 1998 profits of oil producers to fall 2%, according to researchers First Call Corp., down from the forecast of flat profits a month ago.

Much has been said in recent years about how conventional accounting misrepresents a corporation's real financial position. The concern is that analysts and investors cannot make informed financial decisions without understanding the impact of inflation. Accordingly, the type of accounting measurement system used as well as its interpretation is an essential issue to all user groups. The measurement income is also relevant to a wide range of concerns including share prices, businesses stability, wages, job security, and economic growth. In the context of the MNE, these concerns are heightened by the existence of user groups with constituencies located in different countries with different traditions of accounting measurements. While there may be some recognition of the necessity to introduce a system of accounting for price changes or inflation accounting, except in countries such as Germany where it is considered likely to institutionalize inflation, the term inflation accounting covers a variety of possible methods. The major alternative approaches are “general purchasing accounting” and “current value accounting.”<sup>6</sup>

It is also important to consider the real and nominal interest rates. The real interest rate is the percentage increase in buying power achieved when considering the interest rate/inflation. Because inflation is so common and persistent throughout the world without regard to your geographic location it is important to not whether there will be inflation

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<sup>4</sup> Gray, Sidney J., Radebaugh, Lee H., *International Accounting and Multinational Enterprises*, Fifth Ed., Page 290, 2002.

<sup>5</sup> [www.businessweek.com](http://www.businessweek.com)

<sup>6</sup> Gray, Sidney J., Radebaugh, Lee H., *International Accounting and Multinational Enterprises*, Fifth Ed., Page 290, 2002.

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buy how much. Inflation accounting helps to reduce the impact of inflation. Whereby 1) cash can lose value, lost purchasing power; 2) In high inflation, historical cost approach not appropriate to give complete truthful picture of a company's income, profitability, and financial position; 3) Replacing inventory is more expensive replacement cost on fixed assets; 4) Overstatement of income because shareholders demand more dividend while increasing salaries for employees; and, 5) The overstatement of untruthful profits causing investors to make uninformed financial decisions without knowing inflation.

### **Impact of Inflation on the Corporation Summarized**

1. Need current data on inflation.
2. Financial assets such as cash lose purchasing power.
3. Financial liabilities gain purchasing power since you pay back with cheaper dollars;  
however, interest rates tend to be quite high.
4. Sales revenues are matched with older cost of goods sold and depreciation expense.
5. Inflated profits could lead to demands for higher dividends and higher wages.

To further emphasize the approaches to inflation accounting I have included a summary of the proposed approaches to inflation accounting that will lead us into the next question.

### **Historical Cost Accounting**

- Irrelevant in an inflationary environment.
- Since it does not disclose the effect of inflation on the company's financial position.

### **Price Level Adjusted/Historical Costs**

- Fails to account for the effect of inflation on non-monetary items (land).
- Deals only with gain/loss in purchasing power.
- Fails to report current value.
- Does not report the true financial position.

### **Current Value**

- Consider change in non-monetary.
- But, ignores gains/losses on holding net monetary.
- Use replacement cost to make change against revenue, but accumulation may not be enough.

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### **Price Level Adjustment**

- Purchasing power and current value combined
- Assets are valued at their current sales as of balance sheet date.
- Income statement would report all realized and unrealized gains and losses from holding monetary and non-monetary net assets.

### **Question 2: Compare and critically comment on the philosophies behind the following:**

- ◆ General Purchasing Power
- ◆ Current Value Accounting
- ◆ Current Value-General Purchasing Power Accounting

### **General Purchasing Accounting**

The major alternative approaches to accounting for price changes and inflation are GPP accounting and current value accounting. GPP accounting includes all systems designed to maintain the current (constant) purchasing power of the corporation's equity. And, the later we will discuss the current value accounting, on the other hand, includes all systems designed to account for changes in specific prices such as current exit (or selling) price accounting I will discuss in the subsequent section. Objective of GPP is to report assets, liabilities, revenues and expenses in units of the same purchasing power. Non-monetary nominal asset values are restated using to end of year price index, monetary asset and liabilities are not restated. There are many who believe that monetary assets should be adjusted to reflect purchasing power changes.

The consumer price index is the most widely used adjustment index.

The general philosophy supporting general purchasing power accounting is to report assets, liabilities, revenues, and expenses in units of the same purchasing power. The approach here is that the monetary unit of measure should be uniform while retaining the basis of measurement used in the financial statement. For example, historical cost.

The basic philosophy behind the general purchasing power accounting is that financial statements are prepared on a historical cost-nominal currency basis. This means that the statements are not adjusted for changes in the general price level. Under GPP accounting, the non-financial items in the financial statements (inventory, plant, equipment) are restated to reflect a common purchasing power, usually at the ending balance sheet date. The example provided in the text gives us the numerical example to assume that the firm purchased machine on January 1, 2001, for \$10,000 and that the general price level, as measured by the consumer price index, increased by 15 percent during the year.

On December 31, the machine would appear on the balance sheet at \$11,500 + [\$10,000 X 0.15]) from which depreciation would be deducted, adjusted in GPP terms, to be charged against income. This implies that it would take \$11,500 of end-of-year

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purchasing power to buy what \$10,000 bought on January 1. It has been suggested that GPP accounting should be applied to financial assets and liabilities as well. Cash, for example, loses purchasing power during an inflationary period because it cannot purchase as much at the end of the period as it did at the beginning. Debtors benefit with cash during inflation, however, because they can pay their debts at the end of the period with cash whose purchasing power has fallen. Therefore, a firm that has increased its net financial asset position during an inflationary period suffers a loss in purchasing power, whereas a firm that has increased its net financial liability position enjoys a gain in purchasing power. The GPP accounts would reflect this loss or gain in a separate monetary items adjustment.<sup>7</sup>

Lastly, a further issue concerns the nature of the index to be used to make the GPP adjustments. As we noted earlier, the consumer price index is the one most widely used around the world to measure inflation. It measures the prices for a wide range of consumer goods and services that are purchased for final consumption. However, because the index is consumer oriented, it may not necessarily reflect the change in prices that directly affect a given corporation.<sup>8</sup>

### **General Purchasing Power Accounting Summarized**

1. Account for changes in the general level of prices; the general purchasing power of money.
2. Terms: General purchasing power accounting, constant dollar accounting, general price level accounting, current purchasing power accounting.
3. The use of inflation accounting is not well developed.
4. Concern that the value of money has gone down.
5. Can be used separately or in conjunction with current value accounting.
6. Need to determine which accounts are to be adjusted, the basis for the adjustment (which index), where the adjustment is to be reflected in the financial statements.
7. The monetary unit should be uniform while retaining the basis of measurement of assets (like historical cost).
8. Historical cost, constant dollar approach.
9. Non-financial assets are restated to a common purchasing power, generally at the closing balance sheet date.

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<sup>7</sup> Gray, Sidney J., Radebaugh, Lee H., International Accounting and Multinational Enterprises, Fifth Ed., Page 292, 2002.

<sup>8</sup> Gray, Sidney J., Radebaugh, Lee H., International Accounting and Multinational Enterprises, Fifth Ed., Page 290, 2002.

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10. A net financial asset position would lose value during inflation; could measure this as a separate monetary item adjustment.
11. Consumer price index is often used.

### **Current Value Accounting**

According to the readings the benefits of replacement cost information is generally equal to that of the current value method. Therefore, our discussion will focus on the current method. Firms can find a benefit in using a current cost in that this approach is the most widely accepted method, is used for most classes of non-monetary assets. Under this approach, assets are valued at what it would cost to replace them. However, whether the value should reflect the same asset being replaced or similar asset performing the same function with a newer technology.

The historical cost model creates problems when shareholders come to read the accounts in an attempt to understand the value of a company's assets and liabilities. "Amounts reported in financial statements under both the conventional accounting model and the ideal formulation of the conventional accounting model is aggregations of dollars of different dates because assets and liabilities are measured at the specific prices prevailing when they were acquired or incurred," the monograph argues. "This impairs the comparability of the information reported, and the extent of this impairment is not transparent to users of financial reports." If historical cost as a measurement criterion is considered to be a problem, the other extreme – a focus on market selling price accounting – also has its difficulties. Not every asset is sold in an active market and it may be difficult in some cases to find its market price. Specialized plant and equipment is one example of assets that may be difficult to sell or lack observable market prices. For some companies – particularly those with less tradable assets – measuring assets at net selling prices would produce a nonsense result as these assets provide value to the company well in excess of the "scrap value" or "zero value" that would be reported under a full-blown market selling price model.<sup>9</sup>

The monograph recommends a different model be adopted – "the relative current value accounting" model. This model, which prefers depreciated replacement cost to market selling prices for viable assets, sits comfortably between the two extremes and is able to cope with a greater range of accounting problems. The relative current value accounting model also solves some problems relating to the lack of relevance of historical costs, with the ultimate goal of ensuring all stakeholders in a company get information that is relevant and timely for decision-making. A key disadvantage of the relative current value accounting model is future economic benefits arising from outlays on certain intangibles are expensed immediately because they cannot be reliably measured. As with other

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<sup>9</sup> [www.fasb.org](http://www.fasb.org)

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measurement models, this results in understated profit figures when the outlays are made because of the boilerplate requirement that the benefits must be reliably measured.<sup>10</sup>

The replacement cost information is likely to give insights into the trading results by following the recommendations of the IAS 15. Stating that the amounts of the adjustments to or the adjusted amount of depreciation of property, plant, and equipment. Secondly, the amount of the adjustment to or the adjusted amount of cost of sales. Thirdly, adjustment relating to monetary items, the effect of borrowing, or equity interests when such adjustment have been taken into account in determining income under the accounting method adopted in addition to a few more categories listed in the text. In direct listing of the question for the group, geographic, and business are listed below.

Furthermore, more directly related to the segments of group, geographic, and business. The effects of replacement cost of the historical cost show replacement cost operating results exclude stock holding gains and losses and reflect the average cost of supplies incurred during the year, and thus provide insight into underlying trading results. Stock holding gains and losses represent the difference between the replacement cost of sales and the historical cost of sales calculated using the first-in-first-out method. Lastly, current value accounting does consider changes in non-monetary items, but then ignores the gains and losses on holding net monetary items, but then ignores the gains and losses on holding net monetary items. It is argued that when purchasing prices of non-monetary assets change, using replacement costs to make charges against the revenues of the period will serve to maintain the operating capacity of the firm. The following section is created to overview the relevant areas in current value accounting.

### **Current Value Accounting Summarized**

1. Account for current values or changes in specific prices; concerned that the cost of specific assets has gone up.
2. Income is not considered to be earned until capital is maintained in current value terms.
3. Important terms- Current cost accounting, replacement value accounting, current exit price accounting.
4. Concern that the cost of specific assets has gone up or down.
5. Current cost or replacement cost—entry price.
6. Net realizable value—exit price.

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<sup>10</sup> [www.fasb.org](http://www.fasb.org)

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- a. Liquidation value
  - b. Going concern
7. Holding gains and losses—can be taken to income or a capital adjustment account.

### **Current Value-General Purchasing Power Accounting**

The above section discusses GPP and current value accounting. Many accountants and economists believe that the two should be combined in a real value accounting system. The following section is a numerical example provided in the text, showing the detailed nature of the real nature accounting. Which, as stated, is a combination of both accounting elements above. Assume, for example, that an asset was acquired at the beginning of the year for \$150,000 and that at the end of the year the current value of the assets was \$190,000, but the asset measured in end-of-year GPP terms was \$165,000. The total holding gain of the asset would be (\$190,000-\$150,000=\$40,000). However, the real holding gain (the gain net of the impact of inflation) would be only \$25,000. It is important to note that changes in the general level of prices (inflation) will tend to differ from changes in specific prices (current values) relevant to the corporation. Certainly, even zero inflation may be the outcome of a number of specific price changes, which, on average, show that no inflation has occurred. The impact that matters, from the corporation's perspective, is the net impact of prices directly affecting the corporation relative to the average level of prices affecting the GPP of money.<sup>11</sup>

### **Current Value—GPP Accounting Example Problem**

- 1. A real value accounting system
  - \$190,000 End of year current value of assets
  - 150,000 Historical cost of asset
  - 40,000 Total holding gain of asset
  - \$190,000 End of year current value of assets
  - 165,000 End of year value in GPP terms
  - 25,000 Real holding gain net of inflation

### **Question 3: The Mexican Investment**

- A) Which example of transnational financial reporting is Travis confronting here? Why might this Mexican company take this approach?**

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<sup>11</sup> Gray, Sidney J., Radebaugh, Lee H., International Accounting and Multinational Enterprises, Fifth Ed., Page 293, 2002.

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Transnational financial reporting refers to reporting across national boundaries or, more specifically, to reporting financial results to user groups located in a country other than the one where the company is headquartered. A Mexican company is engaged in transnational financial reporting whenever it sends an annual report to a citizen of another country in this case the U.S.

Transnational financial reporting has been encouraged by two phenomena. the first may be termed the global financing strategies of multinational corporations. Global financing includes 1) listing a company's capital stock on stock exchanges outside the home country, 2) selling bonds in various countries, and 3) arranging for loans with foreign banks. Multinational corporations no longer look exclusively to the stock market, bond markets, and banks of their respective home countries to raise capital. They go wherever the money is most available and cheapest. The second phenomenon is directly related to our question being transnational investing . Those with funds (Travis) to invest buy the stocks and bonds of a Mexican company.

The example that Travis is facing here is the **do nothing approach** taken by the Mexican corporation. A corporation that sends the same financial statement to the foreign user as it does to the domestic user has done nothing to accommodate the foreign user. The financial statements are written in the Spanish and use pesos as the currency unit and accounting principles. This approach puts the entire burden of understanding the financial report on the user, and it more or less assumes that the report for readers at home is useful to readers in other countries as well.

This is the most common approach of multinational corporations. Why would a corporation choose to seemingly ignore the information needs of its foreign readers? First of all, if the company raises very little capital outside the borders of its home country, the added expense of taking one of the other four approaches may not be worthwhile. While global financing is becoming more commonplace, many corporations that manufacture and sell products multinational still raise most of their capital in a single nation- the home country. These companies perceive little benefit in preparing financial statements for readers other than those at home.

A second reason a Mexican company may choose to provide financial reports in these currencies is to entice international investment. One way to accomplish this is by selling large blocks of their securities directly to sophisticated overseas investors, such as pension funds. Or they may meet directly with investment firms, referred to earlier, to encourage the firms to recommend investments in their securities. Large investment firms, especially, employ analysts who are skilled at interpreting financial statements in the original form. Either way, these multinationals attempt to attract foreign investors without incurring the extra costs associated with the forms of transnational financial reporting.

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A third reason why a multinational corporation may choose to do nothing is that the language, currency unit, and accounting principles of its home country are well known and understood around the world. This is true, for example, of U.S. and U.K. companies, which almost always take this approach. U.S. and U.K. accounting standards are highly regarded and generally understood in other parts of the world. Both the U.S. dollar and the British pound are international currencies, and the English language is referred to as the language of business. therefore, financial reports useful to native readers may very well be useful to foreign readers.

**b) What must Travis do to make the financial statements more understandable?  
And, c) where can he go to learn about Mexican accounting principles?**

Travis can take a course of action. One would be to get someone to translate the report into English, while you learn a;; you can about Mexican accounting principles. (Several large CPA firms publish such information, and books are also available on the subject). However, this choice would be time-consuming and could even cost you money if, for example, you had to pay someone for the translation. Having this done, the accounting information would still not be directly comparable to that of a U.S. company. In most cases, it is possible for Travis to restate financial accounting information so that it conforms tot he accounting practices of another country. Another course of action is to forgo trying to understand the Mexican companies financial reports and instead rely on the advice of and expert, such as a stock broker. In fact, investment firms employ people to analyze foreign companies' annual reports and to make recommendations about which companies seem to be good ones to invest in.

In addition to the resources to understanding the financial statements discussed above Travis and visit the international accounting standards board website at, [www.iasc.org](http://www.iasc.org), to analyze the accounting standards of Mexico. Additional resources can be found on the Internet; however, the most reliably resources are located in book, research journals, publication of large CPA firms, and from international financial accountant doing business in Mexico.

Due to Travis' interest in NAFTA and the effects of this large trade block in increasing his investment he can also visit research and publications regarding the standards of accounting to enter the NAFTA agreements. Some of the information would prove to be useful when forecasting investments in Mexico. The actual translation process depends on which currency (pesos) the books and records of the Hispanic entity are kept in and how the parent company defines the functional currency of the foreign entity. Accounting differences between Mexico and the U.S. on the relation between equity prices and accounting information reported in the two countries. The influence of U.S. accounting in Mexico is evident in several areas, partly due to the presence of numerous affiliates of U.S. multinational corporations, and also due to the prominence of local representatives of the Big 5 international accounting firms.

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Still, the Mexican accounting and reporting model addresses special issues—such as inflation accounting—in a manner different from that of the U.S. Using the population of Mexican firms listed on U.S. exchanges as American Depositary Receipts (ADRs), we assess the relationship between Mexican ADR prices and Mexican vs. U.S. GAAP earnings and equity. We find that although Mexican ADR firms are not required to reconcile their inflation accounting to U.S. GAAP, ADR prices are significantly related to Mexican GAAP net income. However, we find no significant relation between the ADR price and net income and equity reconciliation's from Mexican to U.S. GAAP. These results call into question the validity and usefulness of the SEC's required reconciliation's to U.S. GAAP.<sup>12</sup>

Some additional areas to be strongly considered by Travis should include the following:

- **Tax planning:** While the NAFTA does not affect the tax regimes in the three countries directly, companies new to the Mexican or U.S. markets are looking to accountants for tax planning advice — concerning business income, expatriate earnings and repatriation strategies, to name a few areas. Inadequate or faulty tax planning could wipe out the benefits of lower tariffs.
- **Market access documentation:** Many businesses need advice on dealing with customs laws and import duties. The complex rules of origin, which determine whether products are eligible for duty-free treatment (and which vary between industries) must be interpreted, and the correct documentation prepared.
- **Foreign currency management:** Foreign currency transactions can expose a company to possible gains and losses caused by exchange rate fluctuations, and many companies need advice on how to minimize the associated risks.
- **Market intelligence:** A successful business venture requires proper research and planning. Firms seeking to expand need to obtain information on target markets, which involves conducting feasibility studies and determining how to adapt products to the markets being explored. They also need assistance to open new facilities, as well as introductions to the appropriate contacts — including attorneys and bankers — and follow-up advice on logistics and distribution issues.
- **Export financing:** Many Canadian firms, especially small- and medium-sized ones, require access to export credit, working capital and other financial services when entering a foreign markets.

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<sup>12</sup> [www.businessweek.com](http://www.businessweek.com)

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- **Information systems:** Firms operating across borders often need sophisticated information systems. At a minimum, company systems must be able to handle foreign currency transactions, and many firms require more comprehensive systems capable of handling customs documentation and tracking the origins of raw materials and goods, in order to prove that they qualify for lower tariffs as NAFTA-originating goods.

The NAFTA takes one more step in moving the accounting profession down the path to globalization. It offers accountants in all three countries new practice opportunities in both traditional accounting services and in new areas, as discussed in this article. And these opportunities are only the beginning. Almost from the outset, the NAFTA was not viewed as an end in itself. Rather, it was seen as the first step toward building a broader Western hemispheric free trade area, stretching from the port of Anchorage to Tierra del Fuego. This aim was reaffirmed at the 1994 Summit of the Americas, where the leaders of the Western hemisphere called for the creation of a free trade area by the year 2005.

Consequently, Latin American countries have been undergoing significant economic restructuring. Throughout the region, many changes are taking place: trade barriers are being lowered, state-owned companies privatized and the door to foreign investment pried open. In return, Latin American countries, starting with Chile, are seeking to join the NAFTA in order to gain an internationally recognized “seal of approval” as a suitable site for foreign investment. By being creative and alert to the opportunities, your firm can position itself for success in NAFTA’s growing services market.<sup>13</sup>

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<sup>13</sup> [www.businessweek.com](http://www.businessweek.com)