Accounting and Financial Reporting for International Trade Offset Obligations

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ABSTRACT

International trade is increasingly conducted with goods and/or services rather than with cash. One such countertrade arrangement is offset, where the seller commits to the buyer’s government to make stipulated investments in the country. Unlike with many other business issues, the accounting and financial reporting treatments of international trade offsets has never been specifically addressed by American accounting rule making bodies. As a consequence, offsets can be handled several different ways, including being completely omitted from the financial statements. By 2014, however, American accountants will be following the directive of the London-based International Accounting Standards Board (IASB). This group has also thus far failed to address the accounting and financial reporting of international trade offsets. Nonetheless, there are elements of the IASB’s pronouncements that provide hope that trade offsets will get the disclosure they deserve. These include 1) looking at the implicit as well as explicit terms of the offset agreement, 2) looking at so-called constructive liabilities which exist not from legal obligations but from customs and past behavior, and 3) the elimination of the contingent liability catch-all. The IASB’s existing and anticipated pronouncements related to liabilities give hope that international trade offset obligations will wind up on balance sheets where they belong.

INTRODUCTION

Traditionally, international trade activities have involved cash or credit agreements. In recent years, however, so called “countertrade” arrangements, where the seller is required to accept goods, services, or trade, in partial or whole payment for its products, have been increasingly important in facilitating international trade. There are several reasons why such arrangements have grown more pervasive. These include opportunities to enter new markets, to deal with new partners in established markets, to work with governments strapped for cash, to reduce or eliminate problems caused by fluctuating currencies, to maintain better control over the outflow of proprietary technological information, and to conduct business in times of severe financial distress as we have been recently experiencing.

“Countertrade” is an umbrella term that has come to mean all forms of reciprocal or compensatory trade arrangements. Specific forms of countertrade include 1) barter, where a direct exchange of goods is effected under a single contract without the use of money, 2) counterpurchase, where a seller agrees to buy an equal amount of products or services from the buyer in a separate contract, 3) buy-back, where the seller agrees to buy all or some of the resultant output produced from the original sale, and 4) offset, where the seller commits to the buyer’s government to make investments in the country, such as local purchases of goods and services, local employment, domestic content, co-production and technology transfer. While there are interesting accounting and financial reporting issues concerning each of these countertrade variations, this paper examines only the accounting for international trade offset obligations.

OFFSETS

Offset occurs when the seller agrees to buy (or cause third parties to buy) products or services from the buyer (or third parties in the buyer’s country) or to make joint venture investments in the buyer’s country. In essence, offsets are concessions required by foreign governments as conditions of the sale. They are especially prevalent for government funded infrastructure projects, such as the building of roads, bridges, water treatment plants, etc. and in the purchase of military hardware. Such offsets are mandated by governments as a way of maintaining domestic employment,
developing an industrial base or an underdeveloped segment of the economy, acquiring modern technology, training, and education, as well as assisting with balance of payments issues.

Offset agreements specify the monetary threshold for offsets, the level of offset required (which is normally expressed as a percentage of the original sales contract), the involved offset sector - civilian and/or defense, and the extent of multipliers. Multipliers are important because countries use them to encourage contractors to undertake more highly desirable activities. For example, if a contractor assists a country in a $1 million export of a product of particular importance, the exporting country could offer a multiplier of 10, thereby increasing the amount of the offset credit to $10 million. Agreements will also include milestones for measuring compliance, the penalty for non-compliance, any required oversight procedures, and how long the seller-contractor has to satisfy their obligation. Table 1 presents some offset specifications of several countries. [United States Department of Commerce, 2007]

<table>
<thead>
<tr>
<th>Country</th>
<th>Threshold Value</th>
<th>Minimum Offset</th>
<th>Required Offset Sector</th>
<th>Multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>€ 10 million</td>
<td>120%</td>
<td>Defense</td>
<td>Up to 10</td>
</tr>
<tr>
<td>Israel</td>
<td>US $0.5 million</td>
<td>35%</td>
<td>Defense</td>
<td>1-1.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>€ 5 million</td>
<td>100%</td>
<td>Defense &amp; Civilian</td>
<td>Up to 30</td>
</tr>
<tr>
<td>Poland</td>
<td>US $17 million</td>
<td>100%</td>
<td>Defense &amp; Military</td>
<td>Up to 5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>US $17 million</td>
<td>100%</td>
<td>Defense &amp; Civilian</td>
<td>Max 2-3</td>
</tr>
<tr>
<td>Taiwan</td>
<td>US $10 million</td>
<td>70%</td>
<td>Defense</td>
<td>1-10</td>
</tr>
<tr>
<td>Turkey</td>
<td>US $10 million</td>
<td>30%</td>
<td>Defense &amp; Civilian</td>
<td>1-5</td>
</tr>
</tbody>
</table>


Offset arrangements can involve both direct and indirect obligations. Direct offsets comprise activities related to the subject of the contract, such as transferring dollars and/or work and technology to the recipient country. This is often accomplished through licensing or joint production. Indirect offset obligations are all other types of activities, services, technologies, know-how, etc. that create new products or rejuvenate existing ones, create new jobs, create value added, improve competitiveness, and increase export opportunities. Fulfilling indirect offset obligations has become an increasingly arduous task for defense contractors who must compete with civilian contractors, as well as with independent investors, for ever scarcer viable commercial opportunities. Unfilled global offsets were expected to reach $100 billion by 2010. [Tricolom, 2009] Not surprisingly, a cottage industry of consultants and organizations has developed who assist contractors in activities well outside the expertise of most contractor-obligors, such as in market intelligence, feasibility studies, screening partner candidates, initiating contacts, site visits, negotiation support, sourcing strategies, regulatory and tax advice, as well as the creation and administration of graduate and training programs. To assist companies in fulfilling their offset obligations and to insure that the offsets are most meaningful and focused, Kuwait has even set up a state-owned National Offset Company that coordinates offset activities and helps to establish joint ventures with Kuwaiti companies. [Ameinfo.com, 2007] The United Arab Emirates established a similar mechanism for defense suppliers in 2010. [Zawya.com, 2011]

Current Accounting and Financial Reporting for Offsets

Unlike many business issues, neither the accounting rule making body for the private sector, the Financial Accounting Standards Board (FASB), nor its predecessors has issued a pronouncement dealing specifically with the offset obligations arising from international trade transactions. Given the growth of international trade and the growing presence of offsets, one might think differently. Further, perhaps because the rise of offsets has been so rapid, the accounting literature on the topic is virtually nonexistent.

Without specific guidance on offset obligations, current accounting and financial reporting is conditioned by FASB Concept Statement #6 which states that:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [FASB, 1985]
Statement #6 also states that the word probable is included “…with a general, not accounting or technical, meaning and refers to that which can be reasonably be expected on the basis of available evidence and logic but is neither certain nor proved.” [FASB, 1985]

The word probable is the bugaboo here. The reason that another term might have been preferable is that inclusion of the term probable has invited questions of just how probable something must be to meet the definition. For example, many accountants interpret the word probable in terms of FASB Statement #5, Accounting for Contingencies. Statement #5 treats probable as meaning likely to occur, as distinguished from reasonably possible (less than probable but more than remote) and remote (slight chance of occurring). [FASB, 1975] Interestingly, the accounting and financial reporting for each level of probability is quite different.

As a consequence, depending on the details of the contract, the intentions of management to fulfill the offsets, how the offsets may be fulfilled, when the offsets may be fulfilled and the likelihood of enforcement by the buying country, offsets for a US international seller may 1) create a probable liability which must be recorded in the accounting records, presented in the financial statements, and perhaps detailed in the footnotes to the financial statements, 2) create a contingent liability, a liability which is reasonably possible, which needs to be detailed only in the footnotes to the financial statements, or 3) create an unrecorded and undisclosed obligation if fulfillment only has a slight chance of occurring.

Even though billions of dollars are collectively obligated by American companies to foreign countries for offsets, it is rare for the term to appear in corporate financial statements. Given the flexibility currently afforded in the accounting and financial reporting of trade offsets, perhaps this outcome is predictable.

Enter the International Accounting Standards Board

Financial statements of U.S. domiciled companies have long followed the directives of the aforementioned FASB. However, over FASB’s tenure there has been tremendous growth in international money and capital markets, commerce, and equity holdings. Further, at all levels, a collective realization has emerged that national differences in accounting standards are unnecessary barriers that make cross-border comparisons difficult and retard the international flow of money and capital. Additionally, as many American companies have global operations and have their stock listed on several stock exchanges worldwide, the cost of preparing financial statements using different standards cannot be dismissed. Hence, in a 2002 meeting the FASB and the International Accounting Standards Board (IASB) issued a memorandum of understanding. The IASB is a London based accounting rule-making group which issues international financial reporting standards (IFRS) now followed by publicly traded companies in over 100 countries. This marked a critical step toward formalizing their joint commitment to converge U.S. accounting standards with those used internationally. Since then both the FASB and the IASB have been vigorously conducting joint projects with the goal of eliminating differences in several important areas.

Subsequently in 2008 the U.S. Securities and Exchange Commission (SEC), the governmental body legislated to oversee the development and application of accounting principles, proposed a roadmap for initially allowing and eventually requiring U.S. companies to report financial results in accordance with IFRS issued by the IASB. Voluntary application of IFRS by some large global U.S companies began in 2009 with mandatory adoption scheduled for all U.S. companies by 2014. Obviously, the 2014 date can be changed by any number of unforeseen events and circumstances and, to the writer, 2016-2018 seems more reasonable. However, within the American accounting profession, the question of whether or not IFRS will be required is no longer discussed; the question asked now is exactly when IFRS will be required.

Generally stated, current U.S. Generally Accepted Accounting Principles (GAAP) and IFRS are oriented differently. Current GAAP tends to emphasize the application of rules. This is perhaps the outgrowth of the litigious environment in the U.S. Alternatively, IFRS tend to be based on the application of principles. Principles-based standards require management to exercise more judgment in determining how to account for and report transactions.

The remainder of this paper examines the IFRS as they relate specifically to the accounting and financial reporting of international trade offset obligations. It discusses whether the use of IFRS will likely mean more
transparency of offset commitments than is currently afforded or whether these significant obligations will continue to be overlooked.

**International Accounting Standards Board**

The IASB has also not issued any specific directives related to the handling of international trade offset obligations. Thus, as with the FASB situation already discussed, we have to get guidance from the entire body of the IASB’s work dealing with liabilities, obligations, and the like. In 1998 IAS #37 Provisions, Contingent Liabilities, and Contingent Assets was issued by the IASB. After several years of application it was evident that substantial revisions to this pronouncement were needed. Hence in mid-2005 the IASB issued an Exposure Draft to amend IAS #37. [IASB, Exposure Draft, 2005] In light of the comments received, the IASB developed more guidance on the proposed measurement requirements in a sequel exposure draft issued in 2010. [IASB, Exposure Draft, 2010] The final revised standards are not expected to be issued until 2012 at the earliest. [IASB, Projects, 2011]

**IAS#37**

According to IAS #37, “a liability is a present obligation of the entity that arises from past events, the settlement of which, and to cancel, is expected to result in an outflow from the entity of resources embodying economic benefits.” [IASB, 1998] This definition is similar to the FASB’s. It goes on to define an obligating event as “an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. Further, a legal obligation is an obligation that derives from a contract through its explicit or implicit terms, legislation, or the operation of law. A constructive obligation is an obligation that derives from an entity’s actions where “(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.” [IASB, 1998]

**Explicit and Implicit Terms** Several terms within these definitions are significantly different from anything provided by FASB. First, the IASB recognizes that contracts have both explicit and implicit terms. Explicit terms are those set out in the contract to measure performance. Implicit terms may be considered those that are assumed or implied but are not directly stated. It could be said with some certainty that all contracts have both explicit and implicit characteristics. Noting implicit terms has important ramifications, especially for military procurement offsets. For example, the following quote from a defense industry journal is typical of those often found in that sector’s literature which essentially notes the explicit and implicit dimensions of an offset contract:

The consequences of a contractor failing to meet its offset obligations are determined in large part by whether the offset agreement characterizes the obligations as “best efforts” or “mandatory.” If best efforts are required, the contractor only has a duty of good faith in attempting to satisfy offset terms. Consequently, the duty is closer to a “moral” obligation rather than a “legal” one. Given the looser standard, a contractor should take advantage of best efforts obligations whenever possible… If the offset obligations are mandatory (or binding) the contractor may be subject to a default termination or damages for breach of contract if the offset requirements are not fulfilled. Frequently, however, the offset agreement will contain a liquidated damages clause… It should be noted that if a contractor relies on the imposition of liquidated damages as a mere cost of doing business and consequently devotes little time and effort to performing the offset agreement, it may find itself ineligible for future contracts. Offset agreements often represent not only contractual duties but also the implementation of politically sensitive public policy objectives of the foreign country. A contractor with a cavalier attitude toward fulfilling offset requirements will probably be perceived as possessing little integrity and such a negative image could inhibit severely the contractor’s ability to compete for business in the international marketplace.” [Russin, 1995]

The explicit dimension of the offset agreement is reflected in terms such as “best efforts,” “mandatory,” “default termination,” “breach of contract,” and “legal obligation.” The implicit dimension of the offset agreement is reflected in terms such as “helping with public policy objectives,” “good faith,” and “moral obligation.”
Constructive Liabilities  The second notable exception in the IASB’s pronouncement is the mention of constructive liabilities, a concept of liabilities not recognized by FASB. Constructive liabilities exist not from a legal obligation but from customs, past behavior, as well as management intent or its articulated future plans.

It is clearly possible that a contractor dealing with the same country officials over an extended period of time creates a constructive obligation from the relationship which will relate to the contractor’s current and future contracts.

Contingent Liabilities  Contingent liabilities were included in IAS #37 with a definition almost identical to that offered by FASB. [IASB, 1998] However in the 2005 Exposure Draft to amend IAS #37 and in subsequent progress reports, the IASB has signaled that it intends to eliminate the concept of contingent liabilities. The basis for elimination is that liabilities arise only from unconditional obligations. Hence, something that is a liability cannot be conditional or contingent, and an obligation that is contingent or conditional based on future events occurring does not by itself give rise to a liability. [IASB, 2005] The 2005 Exposure Draft goes on to state that many of the items previously described as contingent liabilities satisfy the definition of a real liability in the conceptual framework. This is because the contingency does not relate to whether an unconditional obligation exists but to one or more future events that affect the amount the will be required to settle the unconditional obligation. [IASB, 2005] The Exposure Draft notes that “when the amount that will be required to settle a liability is contingent on the occurrence of one or more uncertain future events, the liability is recognized independently of the probability that the uncertain future events will occur.” [IASB, 2005] In addition, the Exposure Draft helps to clarify what the word “expected” means in the definition of a liability. In decisions reached since publishing the Exposure Draft, the IASB concluded that expected “does not imply that there must be a particular degree of certainty that an outflow of benefits will occur before an item meets the definition of a liability. Present obligations that are capable of resulting in an outflow of resources meet the definition of a liability, even if the likelihood of the outflow is low.” [IASB, Summary, 2009]

Eliminating the probability cliff-hanger is a conceptual improvement. This has significant ramifications for international offset obligations. With these IASB directives it will be much more difficult for contractors to argue that while they do have a contractual obligation for offsets it is unclear how the obligations will be satisfied, when the obligations will be satisfied, and even if the obligations will be satisfied. For example, the contractor may ask its subcontractors to fulfill some of the offsets for them, may expect to renegotiate the offset contract on more favorable terms due to an anticipated regime change, or may expect to handle the offsets at a greatly reduced cost with side arrangements with ruling families, government officials, and politicians.

A loophole in the IASB’s proposed rules seems to be in area of liability measurement because all obligations must be able to be measured reliably in order to be shown as a liability. This was included in deference to lawsuits where entities may not want to recognize liabilities before a court judgment and/or where management needs to reach judgment about whether the liability exists. Use of estimates is an essential part of the preparation of financial statements and does not of itself undermine the reliability of the statements. The IASB states that except in extremely rare cases, an entity will be able to determine a reliable measure of the fair value of such liabilities. [IASB Exposure Draft, 2010] If an item cannot be measure reliably, details will be disclosed in the footnotes to the financial statements in a manner similar to that which exists for contingent liabilities with FASB. [IASB Exposure Draft, 2010] It will be interesting to see if managements ultimately handle offsets in a similar manner because of the difficulty of measuring them reliably.

CONCLUSION

The IASB’s existing and anticipated pronouncements related to liabilities gives the writer hope that the majority of international trade offsets obligations will find their way onto corporate balance sheets where they belong. The recognition of both explicit and implicit obligations and constructive liabilities, as well as the elimination of contingent liabilities, should provide more meaningful accounting and financial reporting guidance than currently exists. However, since the IASB’s directives are principles-based, and we may never see an IASB interpretation dealing with international offset obligations per se, much will depend on how contractors reach their judgments.
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