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# Accounting Questions: Method of Recording Profit and Loss on Exchange, Reappraisal Values of Quarry Property in Accounts, Purchase Discounts in Department Stores

American Institute of Accountants. Bureau of Information

# Accounting Questions

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### *METHOD OF RECORDING PROFIT AND LOSS ON EXCHANGE*

*Question:* We would like to have your opinion as to the best method of recording profit and loss on exchange on the books of a business where the home office is shipping merchandise to various branches in foreign countries. The rate of exchange in these countries varies considerably from month to month.

If these branches enter the purchases from the home office at the current rate of exchange, their ratio of gross profit will show large variances from month to month, and it is extremely difficult for the home office to ascertain, at the end of the month, from the statements rendered by the branches, whether or not a reasonable percentage of gross profit has been earned. Would it not be more adequate to have the branches enter the purchases from the home office at a standard rate of exchange, and disregard the daily fluctuations? Of course, when remittances are made to the home office the profit or loss on exchange would then have to be taken up. Is there any objection to such procedure?

*Answer No. 1:* The method most generally followed by companies having foreign branches is to have the branches take up the merchandise shipped to them in dollars with corresponding dollar liabilities to the head office, and to have the branches convert these accounts into the local currencies at current rates. The periodical reports made by the branches in these cases are usually expressed in the local currency and are converted into dollars at the head office by using the average monthly, quarterly or annual rates, as the case may be, for the profit-and-loss accounts and the end-of-the-period quoted rates for current assets and liabilities, excepting inventories which the branch would report in dollars. Fixed assets should be converted at actual rates of exchange prevailing at the time when purchased. The difference arising from conversion on the above basis represents an exchange profit or loss which ultimately may or may not be realized, depending upon the exchange situation when the net assets are finally realized. Many concerns doing business abroad try to protect their profits on sales in foreign countries by hedging in foreign exchange, thus endeavoring to offset or evade exchange losses on realization of proceeds of sales.

Regardless of the method of accounting adopted, the foreign branch manager should be informed of the dollar costs to the foreign branch of the merchandise shipped to the foreign branch by the home office, so that he may be able to calculate the prices in the foreign currency at which he must sell his merchandise in order to yield a fair dollar profit. It is sometimes thought desirable (though it is not always done) to have the foreign branch report to the home office both the dollar and foreign currency figures relating to sales and cost of sales.

It should always be borne in mind that the method adopted by the foreign branch in keeping its accounts may affect the amount of the income and other taxes paid in the foreign country and for this reason the inventory of merchandise in the foreign country is sometimes not sold to the foreign branch, or to the foreign company acting as agents or representatives, but remains the property of the home company and is carried even in the foreign branch accounts in dollars only.

The adoption of a standard rate such as your correspondent suggests might make the bookkeeping a little easier, but if exchange with the countries in which he is dealing fluctuates from month to month as much as he suggests, the adoption of a standard rate might simply obscure the true results. We should be inclined to recommend a standard rate only if exchange were fairly stable.

*Answer No. 2:* We are of the opinion that the procedure is proper, and that it would meet the needs of the situation as outlined. In addition to keeping the accounts of the branches on the basis of a standard rate (ordinarily par) of exchange and making an adjustment for the difference whenever remittance is made by the home office, there would naturally be an adjustment made at the close of each year for the difference between the rate used in the accounts and the current rate of exchange with respect to the current assets and liabilities.

The adjustments made at the time of sending remittances together with the adjustment or the difference in exchange applicable to current assets and liabilities at the beginning and end of the year, respectively, would indicate the profit or loss on exchange for the year. However, it is to be borne in mind that this segregation between the trading and exchange elements in foreign commerce can never be entirely accurate when there are violent fluctuations of exchange, as such fluctuations, to some extent at least, affect the prices of goods in foreign markets (or in the American market if goods are imported from abroad). In other words, the selling price of the goods, expressed in the currency in which sold, would be higher or lower than the equivalent of the par of the originating currency plus a normal rate of profit, depending on whether the currency in which the sale is being made is at a discount or a premium compared with the originating currency.

*Answer No. 3:* In our opinion the method is not objectionable but, on the contrary, is quite desirable.

### *REAPPRAISAL VALUES OF QUARRY PROPERTY IN ACCOUNTS*

*Question:* This involves transactions between Corporation A and Corporation B, both corporations being engaged in quarrying. Corporation A is a South Carolina corporation and Corporation B is a Georgia corporation. The plant of B corporation is in South Carolina.

Corporation A purchased the physical property of B at cost as shown by books of B, paying for those assets with capital stock, par value $100. The assets purchased were taken into the books of A at cost.

That was a closed transaction. Tax returns have been made for the period in which this transaction took place and have been approved by the government as no profit or loss on the transaction.

The quarry land operated originally by Corporation A is owned outright by the corporation. The plant purchased by Corporation A is situated on leased land and for this lease a royalty is paid, based on the tons quarried. The depletion on the original land of A corporation was fixed several years ago by the government at two cents per ton quarried. This was done after the government had made a survey of the property.

Three or four months after Corporation A acquired the properties of Corporation B, Corporation A passed a resolution requiring that all the property of the corporation be appraised and the appraisal value written into the books. This appraisal increased the value of the quarry land owned originally by A and the value of the machinery at both plants. Entries were placed on the books charging land and machinery with a figure which would cause those accounts to reflect the appraisal values. This was, of course, offset by a credit to "reserve for appreciation." Corporation A then issued stock, par value $100, for the amount of the reserve for appreciation and put an entry on the books charging reserve for appreciation, thereby closing that account, and crediting capital stock.

In this stock issue that portion representing the appreciation of original property was issued to original A stockholders and that portion representing appreciation on purchase property was issued to original B stockholders. It appears that the appreciated values were purchased by stock.

What I wish to know is how should the property values be shown in the balance-sheet and how should the following items be presented in the profit-and-loss statement:

Depletion on cost
Depletion on appreciation
Depreciation on cost
Depreciation on appreciation.

*Answer No. 1:* The case simmers down to these facts:

(1) That certain capital assets of a corporation have been appraised and the appraised values have been established on the records.

(2) That capital stock has been issued against the surplus arising from such appraisal.

It follows, therefore, that in stating these capital assets in the balance-sheet there must be appended to the description a reference to the fact that these assets are stated at values appraised by blank company as at blank date. Preferably, the details of surplus accounts presented in the balance-sheet should clearly indicate the amount of surplus which arose from appreciation and its elimination by the issuance of stock. In view of the fact that there remains no surplus from appreciation against which to charge depletion of appreciation, it follows, inevitably, that depletion must be charged against operation, based upon appraised values, which will comprise the two elements of depletion of cost and depletion of appreciation. If details of profit and loss are published, the profit-and-loss account should indicate that the depletion therein included is based upon appraised values. The same principles apply to the question of depreciation.

*Answer No. 2:* As to the statement of property values in the balance-sheet, it is our opinion that they should be shown as being at values, "as appraised by . . . as of (date)."

As to the treatment of depletion and depreciation in the profit-and-loss statement, we are of the opinion that no distinction should be made between depletion and depreciation on original cost and on appreciation value, in view of the fact that capital stock has been issued for the amount of the appreciation and that therefore all the depletion and depreciation must be charged against operations.

### *PURCHASE DISCOUNTS IN DEPARTMENT STORES*

*Question:* Are purchase discounts treated by department stores as financial income or are they credited to the departments?

If credited to departments, are they treated as a reduction of cost in computing mark-up?

*Answer:* Purchase discounts are not handled as financial income by department stores. They are treated instead as an addition to the gross profit. The gross profit is stated usually with and without discounts. The mark-up, however, is based on the gross purchase price and the gross profit determined in that manner in the departmental inventory records. The discounts are then credited to the departments in supplementary calculations.

While this method is not entirely uniform it is used by practically all department stores with which we are acquainted.