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Accounting for Profits and Losses on Foreign Exchange for 1935

By Edwin L. Lopata

In 1934 most American corporations, because of exchange restrictions, were forced to acknowledge the impossibility of remitting funds from many foreign countries. As a result there was a complete shift from official rates of foreign exchange which had been used for the conversion of the current section of the balance-sheet at the end of 1933 to open market rates at the end of 1934. It is believed that when the government regulates exchange markets from day to day, with rigid supervision over the transfer of funds, the only acceptable procedure must be the use of market rates. When it is necessary for a government to manage foreign exchange it is apparent that there are difficulties internal, international, or both. Such weaknesses are too often followed by a depreciation of the currency of the country.

As long as most of the world remains off the gold standard, business probably will have to contend with continually shifting foreign exchange rates. Stabilization in the near future is admitted to be doubtful. It may take many years before internal price levels will have been adjusted sufficiently in all countries to effect any satisfactory stabilization.[1] It seems, therefore, that the disposition of exchange losses and gains in ordinary operations and on conversion of balance-sheets is to be a perennially recurrent problem. Corporations would do well to review their foreign-exchange accounting policies so that their own practices may be uniform during the ensuing years. The practice of switching from one theory to another according to which theory fits the annual statement most decorously is to be condemned. Control and comparison are thereby impaired.

In discussing the practices prevalent in accounting for foreign currency items during 1935, it is well to begin with a description of the bases used for conversion. In all of the following discussion, data were taken, whenever possible, from the form 10 (or, as amended, form 8) of the company, on file with the securities exchange commission. In several instances annual reports were used.

Current assets and liabilities (of the thirty companies reviewed —their names appear in the tables on following pages) are gener-

ally converted at the current market rate at the end of the year. Several exceptions to this policy should be mentioned.

The International Harvester Co. converts its current items

"on the basis of the rates used by the companies at Dec. 31, 1932, (except inventories which are partially on the basis of the United States dollar value of merchandise shipped from the United States). The rates used by the companies at Dec. 31, 1932, were the prevailing market rates at that date or slightly lower."

The company explains that the 1932 rates are used pending the stabilization of international exchange. In this way it eliminates all unrealized exchange appreciation and all unrealized market recoveries of exchange write-downs made in 1932 and prior years.

In addition to converting its current items at current rates the Goodyear Company converts preferred stock and funded debt in the hands of the public at current rates.

The B. F. Goodrich Company introduces a variation wherever inventories have been manufactured abroad and exchange fluctuations have been wide. It follows the principle, then, of

"treating the currency at its equivalent in dollars and cents at the time of manufacture."

Standard Oil of New Jersey gives as its basis of conversion the following principles:

"Net current assets exclusive of inventories were converted at year-end rates of exchange after giving effect to forward exchange contracts. Cost of inventories purchased on a dollar basis was computed at the dollar cost to the foreign subsidiary, and cost of other inventories was computed at the dollar cost determined by converting foreign currencies at average rates of exchange over the period of accumulation. Inventories are at the lower of cost, so determined, or market."

A final exception to the general rule is the National Cash Register Company, which converts its inventories at dollar cost.

There is little need for comment when such a unanimity of opinion exists. It seems that current rates of exchange should be used to convert all current amounts on the balance-sheet. An objection must be lodged, however, to the inclusion of inventories at this rate in all instances. The current practice is based on the assumption that the goods and services are sold in a competitive market where prices do not change with fluctuations in exchange rates. This assumption does not hold good for many staple raw materials which move in international trade, especially when one

country possesses a monopoly of supply. Nor may it be valid when any element of monopoly is present; that is, monopoly of service, design, good-will, etc. Therefore, if a condition exists wherein the prices of goods in a foreign market are raised as soon as the foreign rates suffer any measurable decline, an increase in operating profits results and embellishes the record of the foreign-branch managers. Concurrently, a loss on foreign exchange is recorded upon conversion of the balance-sheet.

In such a situation it may be propitious to make an adjustment to present the facts of the situation. At the time selling prices are raised in the foreign country—due to exchange depreciation—the foreign branch or subsidiary could be required to write up the value of that part of its inventory acquired at prior rates, crediting a suspense account against which could be charged the unrealized loss on the intercompany account upon conversion of the balance-sheet. The greatest value to which the inventory should be raised would be the quotation of similar goods at current prices.

The bases of conversion of fixed assets and liabilities are stated in more or less the same manner throughout all of the statements —either at rates prevailing on the dates of acquisition or at average rates at which the assets are carried.[2] Reserves for depreciation on fixed assets are converted at the rates of conversion of the fixed assets. The Chrysler Corporation varies this by converting its assets at the former par of exchange. A problem presented by this practice is discussed under conversion of depreciation expense.

No one basis of conversion of profit-and-loss items is generally accepted. The table on the following page shows those bases which are clearly stated by companies whose forms 10 were examined. Each basis used probably arrives at satisfactory results, yet the selection of one or the other affects the distribution between profits or losses from operations and exchange profits or losses resulting from conversion of the balance-sheet.

The selection of a basis for conversion of profit-and-loss accounts is dependent in part on the concept a company has of the time that operating profits are earned and in part on what it includes in gross operating profits (as well as to the position of the company and the type of business in which it is engaged). If the company feels that only profits should be shown as arising from operations which are actually made available to the parent company—and something may be said for this argument—remit-

tance rates will prove effective. If it feels that profits are to be recorded as realized from operations at the time the subsidiary earns them—and something may be said for this thesis—average rates of a period will prove effective. If average rates are used, and remittance rates are higher than average rates, the company will show a realized exchange gain upon remittance. However, if remittance rates (which are greater than the average rates at which profits were earned) are used for conversion, the operating profit (above the profit that would have been shown by the use of average rates) will be inflated by the amount gained as a result of a rise in exchange rates between the time the profits were earned and the time they were remitted.[3] This principle is valid whether

BASES USED BY VARIOUS AMERICAN CORPORATIONS FOR CONVERSION OF PROFIT-AND-LOSS ACCOUNTS OF FOREIGN BRANCHES AND SUBSIDIARIES

Name of company (abbr.)	Basis used		
	Average rates for year	Current rates accumulated monthly	Others
Am. & For. Power			Rates at which funds are transferred to New York
Am. Rad. & Std. San. Corp.			Year-end rates
Atlantic Ref. Co.		***	
The Borden Co.			Canada at par—English subsidiaries at $4.8665 to £
Chrysler Corp.		***	
Consolidated Oil		***	
Eastman Kodak	***		
Fox Film	***		
General Motors			Prevailing (?) rate monthly
Goodrich			Sales at actual rate on date of sale. Gain on payment to profit-and-loss account
Goodyear		***	
Int. Harvester			Average rate of remittances to U. S. throughout the year
Int. Nickel			Month-end rates
Int. Tel. & Tel.	***		
Radio Corp. of Am.		***	
Socony-Vacuum		***	
Standard Oil (N. J.)			See footnote to this table
The Texas Corp.		***	
Union Carbide			Prevailing rates at end of quarter
United Fruit			Weekly average rates

NOTE.—Standard Oil (N. J.)—"The net income of foreign subsidiary companies to the extent of dividend remittances during the year has been converted into dollars at the rates of exchange current when the dividends were paid. With respect to profits not remitted in the form of dividends during the year, the net income before depreciation, depletion, amortization and retirements was in general converted into dollars at year-end rates of exchange, and from the amount so obtained there were deducted depreciation, depletion, amortization and retirements based on the dollar figures of fixed (capital) assets . . ."

the remittance is in the nature of dividends or payment of inter-company account.

The converse may be shown where remittance rates are lower than the average rates at which the operations were conducted.

The bases used by American companies for converting depreciation seem bound to result in some distortion of the operations of foreign branches and subsidiaries. In every instance depreciation is converted either at the foreign-exchange rates prevailing when the fixed assets were acquired or at the former par of exchange. Where the exchanges have fallen or risen to a permanent level substantially different from that prevailing at the time the assets were acquired and the assets have not been revalued on the basis of the new exchange rates, a capital loss is camouflaged.

Alternatives are suggested for meeting this situation. Their acceptance depends upon the underlying philosophy of the management. If the management feels that the dollar cost to the subsidiary must remain constant, the assets should be written up on the books of the subsidiary, in the terms of the foreign currency. With depreciation then being converted at the same rate as other expenses, the subsidiary will show the same operating profit that the parent company discloses on converting the statement of profit and loss. On the other hand, if the company feels that the value of the fixed assets remains the same for the subsidiary in terms of the foreign currency, and if the subsidiary actually makes a profit each year—which will be eliminated if the parent company converts depreciation at the rate prevailing at the date of acquisition of the asset—the parent company should record a capital loss due to devaluation (or whatever the cause) and convert depreciation at the rate used for other expenses.

The phase of accounting for foreign currency items which shows the most variation between companies is that which deals with the treatment of realized and unrealized gains and losses on exchange in remitting funds and converting the balance-sheet. Several practices are prevalent.

The setting up of a reserve for exchange fluctuations seems to have achieved more following than any other treatment of exchange gains and losses. Both realized and unrealized gains and losses are recorded in this account. Of the 30 policies studied[4] (picked at random from those concerns which might be expected to engage in foreign business) nine, or thirty per cent.,

generally make use of the reserve method. They include the following companies:

Name of company	Source of data
American Radiator & Standard Sanitary Corporation	Form 8
Chrysler Corporation	Form 10
Consolidated Oil Corporation (note 5)	Form 8
Corn Products Refining Company	Report for 1934
The International Nickel Company of Canada	Form 10
International Telephone & Telegraph Corporation	Form 10
Radio Corporation of America	Form 10
Standard Oil Co. (N. J.) (note 6)	Form 8
F. W. Woolworth Co. (N. Y.)	Form 8

It has been rather difficult in each case to determine definitely that the concerns in the next class have closed their exchange gains and losses to consolidated or earned surplus, yet such seems to have been the case. This reflects a feeling that fluctuations in exchanges are a thing apart from current operations of the business and should not be reflected in statements of current earnings.[7]

Name of company	Source of data
American & Foreign Power Company, Inc.	Form 8
Armstrong Cork Company	Report for 1934
The Procter & Gamble Company	Report, June 30, 1933
Union Carbide and Carbon Corp.	Form 10
Westinghouse Electric & Manufacturing Company (note 8)	Form 10

In harmony with a desire to reflect all variations in foreign exchange rates as part of operations, the following companies seem to carry gains and losses to income, regarding the exchange factor as an integral part of operations:

Name of company	Source of data
The Atlantic Refining Company	Form 10
International Harvester Company	Form 8
International Paper and Power Co.	Report for 1934
Socony-Vacuum Oil Company, Inc.	Form 10
The Texas Corporation	Report for 1934

Another procedure which has some measure of popularity is that which attempts to show exchange fluctuations as part of current operations but avoids the unacceptable practice of carrying unrealized gains to income. The following companies generally charge all losses, realized or unrealized, to income. They credit income with all realized gains but hold unrealized gains in reserve. When unrealized gains become realized, it is assumed

that they are transferred from the reserve to income. The clearest declaration of this policy is that of the Goodrich Company. In form 10 it states:

"The net profit or loss on foreign exchange is taken up when the transaction is completed. However, profits not realized on foreign exchange items are held in reserve on the balance-sheet and not taken into profit-and-loss account. On the other hand any anticipated loss based on the method of valuation set out under the balance-sheet notes is taken into the profit-and-loss account. This charge, therefore, represents realized and anticipated losses, less realized gains."

The companies generally following the same procedure as Goodrich are:

Name of company	Source of data
Eastman Kodak Company....................	Form 10 and 1934 Report
General Motors Corporation...................	Form 10
The B. F. Goodrich Company.................	Form 10
The Goodyear Tire & Rubber Company........	Form 8

A fifth practice is one in which all profits and losses are closed to income, with the establishment of a reserve against which may be charged losses of an extraordinary nature—such as those which would result from the devaluation of its currency by a foreign nation. The sources of the reserves can not be ascertained easily, but in all probability they were created in former years when exceptional gains on exchange were recorded. Companies seeming to follow this practice are:

Name of company	Source of data
The Borden Company (note 9).........................	Form 10
The Firestone Tire & Rubber Company (note 10)........	Report for 1933
Fox Film Corporation (note 11)........................	Form 10
The National Cash Register Company (note 12).........	Form 8
United Fruit Company...............................	Form 10

Finally, the two remaining companies of the thirty examined adopted the following programs:

E. I. Dupont de Nemours and Co., in form 10, state, "For purposes of conservatism . . . the equities in the undistributed earnings or losses of certain foreign controlled companies not wholly owned were determined on the basis of converting the accounts of such companies at approximately the exchange rate prevailing when the dollar investment was originally made some years ago." (This statement, of course, does not disclose the treatment of gains and losses.)

The Western Union Telegraph Co., in its annual report for 1934, explained, "Values of the company's current assets and liabilities abroad, mostly in Great Britain, are included in the balance-sheet on the basis of the rate of sterling exchange ruling at the end of 1934 . . . The change since December 31, 1933, in the value of the pound sterling in terms of the dollar accounts for the decrease in deferred non-interest bearing liabilities."

In defense of the multiplicity of procedures adopted, it should be noted that in all probability the selection of one basis or another by companies has been due to the nature of their businesses, and the exigencies of the situations in which they find themselves at various times. While no definite statement can be made on the subject, several conclusions are presented in the following pages.

The nature of foreign business implies that exchange gains and losses should be computed as part of the results of each transaction. No concern would be willing, other things being equal, to conduct operations in a foreign country from which no funds could ever be removed. Nor would it be apt to continue operations if each transaction were characterized by a loss on the transfer of funds, a loss great enough to wipe out the entire net profit. Hence, accounting practice should attempt to carry exchange profits and losses to income wherever possible. Fourteen of the thirty accounting policies investigated, the third, fourth and fifth groups outlined heretofore, follow variations of this policy. I feel that, wherever possible, gains and losses should be credited and charged to profit-and-loss, for the reasons stated above. However, the most desirable practice, in my opinion, is an eclectic procedure. From the standpoint of sound accounting theory, all losses—realized or anticipated—should be recognized as deductions from income, while realized gains should be additions to income. Unrealized gains should be kept in a reserve until they actually become realized. This is in accord with the practices outlined by Eastman Kodak, General Motors, Goodrich and Goodyear. In addition, I suggest creating a reserve which can be used as a shock absorber for unusual losses.

Objection may be raised to the use of this procedure on the ground that it is impossible to segregate realized from unrealized items. The criticism is valid when the books of the foreign branch or subsidiary are kept only in terms of the foreign currency. If the records are maintained in both currencies, realized may be

segregated from unrealized amounts. While it would be desirable to keep accounts in two currencies, it must be admitted that it is a very costly practice. In most cases the results obtained by ordinary accounting methods—especially where average rates of a period are used for the conversion of the profit-and-loss account—are accurate enough over a period to warrant approximate distinctions between realized and unrealized gains and losses on foreign exchange. Where current conditions are such that it is impracticable or impossible to separate realized from unrealized items with any degree of accuracy, the most desirable treatment seems to be the sequestration of gains—against which losses may be charged—in a reserve until international stabilization of foreign exchanges shall have been effected.

Even where accounts are maintained only in the foreign currency, it is possible to determine some profits which are actually realized. Whenever a current asset is definitely segregated, such as a bank balance, any change in the foreign-exchange quotation which results in a profit at the time of remittance may be said to have accrued to the isolated item. In the same way, any part of inventory may be ear-marked as it passes from producer to customer, and unrealized exchange gains may be determined at each stage of the process. These gains could be classed as realized only when United States currency is received in payment for them. A compensatory practice might be the maintaining of records in both currencies for the larger accounts of a business, thereby determining the realized profits for part of a period's transactions. It would give some indication of the percentage of gain or loss ordinarily experienced which was due to fluctuations of the exchange rates.

If American concerns desire the segregation of all ordinary operating incomes and losses from foreign-exchange variations, they should initiate the custom of keeping their records both in the foreign currency and in dollars—at least as long as there is danger of extraordinary fluctuations in the foreign currency. By this is meant the removal of all amounts of additional gross income or loss so far as it is possible. It would be necessary to determine the effect of foreign-exchange movements upon prices received for goods at the time the wares were sold. Again, it would be necessary to determine the accrual of gain or loss from exchange when the receivable was liquidated by payment in a foreign currency. Fluctuations in exchange would also have to

be accounted for when the foreign currency was converted into American money.

However, practical difficulties loom before the adoption of this suggestion in practice. As an alternative I suggest, where records are maintained only in the foreign currency, the following procedures for consideration:

(1) Convert profit-and-loss accounts at average rates for the period selected.

(2) Recognize capital losses upon devaluation.

(3) In recording profits and losses on remittances and conversions:

A. Carry all realized and anticipated losses to profit-and-loss.

B. Close all realized gains to the income account.

C. Credit all unrealized gains to a reserve, removing therefrom to profit-and-loss as they are realized.

D. Set up a reserve for contingencies to serve as a shock absorber for any extraordinary items.

NOTES:

1. There is the possibility, of course, that nations may decide to manage a stable internal price level, and allow the exchanges to vary in perpetuity. I have not taken this eventuality into consideration in the preparation of this paper.

2. The exception of the Goodyear Company, which converts preferred stock and funded debt in the hands of the public at current rates, has been noted. The reader may attempt to determine the implications of this practice himself.

3. An example will serve to clarify the points on conversion of profit-and-loss accounts, an intricate subject at best. The example consists of a series of balance-sheets of a foreign branch, with appropriate remarks on cogent points. In actual operation the time sequence will probably be altered, but the argument will remain substantially the same. I have chosen to select the remittance of profits as the basis for the argument, but the reader may obtain the same conclusions by assuming that the remittances made are on intercompany account.

I

Statement at the beginning of the period

Assets	£	*Liabilities*	£	
Misc.	30,000	Inter co. acct.	30,000	(Assets in all statements are assumed to be current)

II

Showing profits earned in period

Assets	£	*Liabilities*	£	
Misc.	60,000	Inter co. acct.	30,000	($150,000 advance)
		Profits	10,000	(earned at rate $4 to £)
		Profits	20,000	(earned at rate $5 to £)
	60,000		60,000	

III

£30,000 profits are remitted when rate is $4.90

Assets	£	*Liabilities*	£	
Misc.	30,000	Inter co. acct.	30,612	($150,000 advance and rate is now $4.90)
Loss on exchange	612			
	30,612		30,612	

IV

Statement II converted when the market rate is $5, at the *average rate at which profits were earned*

Assets	$	*Liabilities*	$	
Misc.	300,000	Inter co. acct.	150,000	
		Profits	140,000	
		Unrealized gain on conversion	10,000	(arising from converting £10,000 gained at a rate of $4 at $5 to the £)
	300,000		300,000	

V

Statement III converted at market rate of $4.90

Assets	$	*Liabilities*	$
Misc.	147,000	Inter co. acct.	150,000
Loss on exchange	3,000		
	150,000		150,000

VI

Statement II converted when the market rate is $5, at the *rate at which remittance was made*

Assets	$	*Liabilities*	$	
Misc.	300,000	Inter co. acct.	150,000	
		Profits	147,000	
		Unrealized gain on conversion	3,000	($10,000 arising from converting £10,000 gained at rate of $4 at $5, less $7,000 unrealized profit included as operating profit)
	300,000		300,000	

VII

Statement III converted at market rate of $4.90—same as V above

Remarks: The ultimate results are the same in both instances, $147,000 profit. When remittance rates are used for conversion, and they are higher than the rates current when the assets were earned, it results in inflating operating profits by the amount of final gain on exchange.

The preceding example used a weighted average rate for the conversion of the profit-and-loss account. If a simple, arithmetical average is used, unless the figure fortuitously happens to be the same as the weighted average, an indeterminate amount of unrealized loss or gain on exchange will be "buried" in the converted profit-and-loss account.

4. See last paragraph of note 3.

5. Note J to schedule VI, form 8, states, "Net profits or losses resulting from such conversions of foreign currency into United States dollars are credited or charged to a reserve for foreign-exchange fluctuations, or suspended as 'unadjusted debits'".

6. The Standard Oil Co. had a reserve for foreign-exchange fluctuations of $26,130,701.01 at December 31, 1934.

7. While, for reasons stated elsewhere in this paper, I do not relish the practice of closing exchange items to surplus as a regular occurrence, I can see no great objection to carrying extraordinary losses—such as those incurred by the devaluation of a country's currency—to the surplus account.

8. Westinghouse introduces a note of conservatism into the practice of closing exchange items to surplus; the company charges losses to surplus and credits gains to a reserve.

9. The basis for including the Borden Company in this classification should be explained: In 1931 a reserve for net current assets in foreign countries was created from surplus. "At the end of 1933 the adjustment made in 1931 . . . was reversed. . . . The circumstances which necessitated the creation of this reserve did not exist at the close of 1933."

10. While the consolidated balance-sheet records a reserve "for future fluctuations in investments and foreign exchange" of $2,200,000, there is a credit of "other income" in the consolidated income account of "interest earned, income from investments, foreign-exchange adjustments, etc." amount-

ing to $673,301.91. It is questionable, from the evidence given, whether or not this should be classed strictly as one following a "reserve policy".

11. Fox Film set up a "reserve for fluctuation in dollar value of working assets in foreign countries in the amount of $250,000.00" from the profits on foreign exchange (amounting to $669,560.81 for 39 weeks in 1933) at December 30, 1933. This reserve still appeared on the books as of the end of 1934.

12. National Cash Register Company set up a reserve for exchange losses of $430,836.43 from 1933 profits. This was cleared by losses in 1934. In addition, $333,251.08 was charged to income.