1945

Foreign Exchange Accounting.

Shin Min sherman Yui

Louisiana State University and Agricultural & Mechanical College

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LOUISIANA STATE UNIVERSITY LIBRARY
FOREIGN EXCHANGE
ACCOUNTING

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in

The Department of Business Administration

by
Shin Min Yui
B.A., Nankai University, 1938
M.A., University of Pennsylvania, 1940
June, 1945
ACKNOWLEDGEMENT

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He owes a particular debt of gratitude to Mrs. A. E. Bracey for reading and correcting his first draft.
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ABSTRACT

Business men and organizations who deal with foreign exchange transactions always regard them in the light of their own currency. They try to convert the transactions in foreign currency to their equivalents in domestic currency, because the final profit or loss on the transactions can be determined only after the foreign currency is converted into home currency.

Before the gold standard was abandoned, the fluctuation of exchange rates was limited by the gold shipping points; but, later, after the abandonment of the gold standard by many countries, the fluctuation of exchange rates was within a very wide range. International trade thus became a commercial speculation for the reason that the operating profit or loss could be completely wiped out or offset by a sudden change of the exchange rate. The fluctuating nature of exchange rates poses two serious problems before business men or organizations who deal with foreign exchange transactions; first, avoiding the exchange risk; second, recording the transactions logically and systematically. The first problem can be solved easily by using the method of hedging; the second problem is more
complicated and difficult to cope with. An attempt, therefore, has been made herein to design an accounting system to register foreign exchange transactions scientifically.

Of the few books written on foreign exchange accounting, most are devoted to foreign exchange accounting for banks and to mathematical knowledge for conversions. Sources of information for foreign exchange accounting for foreign traders and foreign branches are articles published in the Accountant, the Journal of Accountancy, and the annual reports of various American companies, and other research works.

The methods of foreign exchange accounting applied to different kinds of business organizations differ in accordance with the nature of the business.

(1) Foreign Traders - Importers and exporters who reside in their own country and do business with foreign countries have to establish an Exchange Adjustment account for exchange differences. Exchange Future Purchased or Sold accounts are provided for hedging transactions.

(2) Foreign Investments
(a) Foreign Agencies - Accounting records for foreign purchasing or selling agencies generally are kept in the books of the home
office. The specially designed sales book, purchases book, accounts receivable account, accounts payable account, and cash books are suggested procedures.

(b) Foreign Branches - As an individual unit, the branch books are kept in terms of the foreign currency and separated from the books of the home office. Inter-office transactions which are recorded in one currency on one set of books must be recorded at an equivalent amount in the other currency on the other set books. Inter-office transfers are recorded in Remittances accounts in order to provide reciprocal accounts showing both the foreign currency amount and domestic currency amount. At the end of the fiscal period, the statement of the branch office should be consolidated with those of the home office. Current liabilities and assets are converted at the current rate of the balance sheet date. Fixed assets and long-term liabilities are converted at the rate at the time when the assets were purchased or at the time when the liabilities were actually contracted.

(c) Foreign Plants - The labor cost of constructing
a foreign plant should be converted at the average of the daily rate of exchange during the period. The material costs should be converted at the rate at the time when they were purchased. Exchange profit and loss on funds which are set aside in a foreign country for construction purposes should be handled as follows. In case of loss it should be written off to the revenue account, and in case of gain it should be deducted from the cost of the plant.

(d) Foreign Subsidiaries - Foreign subsidiaries are organized as separate companies and incorporated under the laws of foreign countries. They are carried in the Foreign Investments account during the accounting period. Their statements may be consolidated at the end of the accounting period; but, in actual practice, most of the companies consolidate only their 100% owned foreign subsidiaries.

(3) Foreign Exchange Banks - Foreign exchange banks serve as middlemen in bringing the demand for and supply of foreign exchange together at the market. Their purpose is to make profits by buying foreign exchange at the lowest possible price and selling
it at the highest possible price. Purchases and sales of foreign exchange are recorded through Nostro and Loro accounts. Foreign exchange traders, who are the centers of all foreign exchange transactions, carry out their operations by the use of position sheets.

An accounting method employed to avoid exchange differences is introduced in Chapter X. Its chief principle is to record the transactions in the currency in which the business is carried on and to use the Exchange account as a clearing account for the foreign and domestic currencies.

The effects of currency depreciation and exchange control systems on international trade, from an accountant's point of view, are discussed; and studies are made regarding actual practices of leading American companies during the period, 1931-1939. The only answer for dealing with these emergencies is to adopt conservative accounting procedures.
CHAPTER I

INTRODUCTION

From the origin of the barter system many thousands of years ago to the adoption of modern credit systems, trading methods have become more complicated and have extended across national boundaries. This expansion of trade, of course, can be explained by the development of new methods of transportation, both on land and sea and in the air, but the principal reasons are to be found in the differences in human capabilities, the differences in economic development, and the distribution of natural resources among the several nations. These factors give rise to territorial specialization or territorial division of labor. The value of international trade cannot therefore be measured by the aggregate value of the goods exported or imported by various countries. Trade brings to the consumers in every country the products in which other country specialize, and thus raises the standard of living of all countries.

Trade among nations is different from trade among territorial division within a national community. A country is an individual political unit, within which there is only
one monetary system and where business activities are regulated by the same laws. Trade among nations, on the other hand, involves the use of different systems of currency and different laws regulating business transactions.

After the first World War, the rapid development of nationalism and industrialism in Asiatic and South American countries and the growth of cartelization and rationalization in already industrialized countries have made international trade more complicated. Furthermore, as a result of the depression of 1929 and its aftermath, both European and South American countries adopted regulated trading systems, involving higher import tariffs, quotas, the depreciation of currencies, and the introduction of exchange control.1 The general tendency was toward totalitarianism. International trade was severely hampered during the period from 1931 to 1939. The total volume of world trade declined from 53,104 million United States dollars for the average year 1926-1930 to 23,844 million United States dollars for 1933, and 27,072 million United States dollars for 1938, the year before the outbreak of the second World War.2 Business men involved in international trade faced more trade barriers and regulations than ever before.

1For a full discussion of commercial policy of different countries after the first World War cf. M. S. Gordon, Barriers to World Trade (New York: Macmillan Co., 1941)

Business men and organizations interested in foreign exchange transactions and international trade can be classified into three main groups as follows:

(1) Importers and exporters - those who deal with merchandise and service imports and exports.

(2) Foreign investors - those who operate or own an interest in foreign agencies, foreign branches or subsidiaries, or foreign factories.

(3) Banks and brokers - those who deal in foreign exchange.

Since the characteristics of each of the above classes and the nature of the transactions in which they engage are quite different, their interest in and treatment of foreign exchange transactions likewise vary. It is the purpose of this paper to study the various accounting problems of each of the three groups above with regard to foreign exchange transactions.

As a tool of business management, it is obvious that accounting has to deal with international business conditions whenever enterprises do business in more than one country. Foreign exchange accounting is needed especially to present a systematic record of international financial facts. It comprehends designing and installing a system by means of which the financial facts of international trade may be recorded. It also concerns the preparation of all the statements necessary to present these facts for the guidance of those who may be interested in international
trade, so that they may direct their operations more intelli-
gently.

Accounting for international trade includes cer-
tain problems arising out of foreign exchange which are not
found in general accounting. The term "Foreign Exchange"
is generally defined as

"the method by which settlement is made for inter-
national transactions, in lieu of the actual ship-
ment of gold, and applies to bills of exchange,
drawn by and against residents of different coun-
tries in payment of debts. It also covers other
monetary and credit instruments such as, gold,
silver, banker's drafts, letters of credit and
travelers checks."3

For example, an American who has sold goods or service to
a Frenchman expects ultimately to be paid in United States
dollars. He may be willing, however, to receive a bank
draft on Paris expressed in French francs, because he knows
there is a ready and dependable market in which he can con-
vert French francs to United States dollars. He will sell

---

3R. H. Montgomery, Editor, Financial Handbook,
p. 1495. The term 'Foreign Exchange' is in itself vague and
ambiguous. Franklin Escher defined it as 'the business of
buying and selling orders for the payment of foreign money
at a foreign point. Between any two countries the rate of
exchange is the price of the money of the one expressed in
the money of the other.' cf. F. Escher, Foreign Exchange
it is said in technical phraseology that the exchange are
rising or falling, or that the exchange are at specie point,
allusion is made to the fluctuations in the terms on which
bargains are made between buyers and sellers of foreign
bills.' cf. G. J. Goschen, The Theory of the Foreign ex-
Montgomery's definition is adopted here because of its
broadness.
his draft in French francs at a more or less expected rate to get United States dollars. This process involves the use of foreign exchange rates or ratios to convert values expressed in one currency into their equivalent in other currencies. Therefore, the most significant difference between foreign exchange accounting and general financial accounting is that the former deals with business transactions which involve at least two currencies, but the latter only one.

Foreign exchange rates are just as unstable as other commodity prices, since they are determined also by the law of demand and supply. At times they fluctuate even more rapidly. The leading factors of foreign exchange demand and supply in the foreign exchange market of a country can be classified as follows:4

(1) Demand for foreign exchange is created by:

(a) merchandise imports, when drafts are drawn in foreign currency

(b) capital exports, such as international loans, purchases of foreign stocks and bonds, and investments in foreign properties

(c) payments on foreign investments, such as dividends remitted to foreign investors abroad

---

(d) remittances to foreign countries by tourists, emigrants, or the purchases of other services provided by foreigners
(e) inter-market short-term loans, arbitrage, and speculation

(2) Supply of foreign exchange is created by:
(a) merchandise exports, when drafts are drawn in foreign currency
(b) capital imports, such as international loans, purchases of stocks and bonds by foreigners, and foreign investments in domestic properties
(c) income from investments in foreign subsidiaries
(d) remittances to this country by tourists, emigrants, or the purchases of domestic services
(e) international short-term loans, arbitrage, and speculation

Before the departure of both European and American countries from the gold standard during the thirties, the fluctuations in foreign exchange rates was limited by the gold shipping points, because between gold-using countries there is no difference whatever between by payments made by means of bank drafts and payments made by means of a shipment

of gold. A bank draft is an order addressed to that bank to pay a certain amount of gold. Hence, whenever the rate of foreign exchange is higher than the cost of shipping gold to make the payment, debtors prefer to ship gold. Since shipments of gold decrease the demand for foreign exchange in the paying country, the rate of foreign exchange will tend to decrease. The range of foreign exchange fluctuation is thus limited. But after departure from the gold standard, the bonds between different monetary units are no longer close, and the relation between their values may fluctuate more widely. The ever-changing rates for British pound and French franc, in terms of United States dollars, are illustrated in the tables on the following pages.

The exchange rate of the French franc fluctuated more rapidly than the rate for the pound sterling. During the twenty-two-year period between World War I and World War II, the value of French francs, in terms of American currency, dropped from U.S.$0.1835 in January 1919 to U.S.$0.018516 in May 1940. The rate for the pound sterling is more stable as compared with franc rate, but its changing nature is well illustrated by the average rate each month. It fluctuated constantly between the range U.S.$3.275267 and U.S.$5.153425 during the period.

As a matter of fact, business men who deal with foreign exchange transactions always look at them in the light of the currency of their own country. In other words,
### Table I

**Monthly Average Rate of the Pound Sterling**

**In Terms of U. S. Dollars, (1919-1940)**

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## Table II

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**Source:** Federal Reserve Bulletin, January, 1928, p. 56, and succeeding issues.
they instinctively try to convert, in their minds, trans-
actions in a foreign currency to their equivalent in terms
of domestic currency. They, therefore, regard their own
currency as the stable currency and the currencies of for-
eign countries with which they do business as fluctuating
currencies. For instance, a public utility corporation in
the United States may own a number of public utility under-
takings in South America. They, of course, will appear in
the local foreign books of account in the currencies of the
countries where such enterprises are situated, as the local
transactions take place in those countries. The annual
balance sheets and profit and loss statements, however, must
be furnished to the stockholders in the United States. If
those statements are presented in terms of Brazilian milreis
or Argentine pesos, they would probably be unintelligible to
the investors in the United States. It is necessary, there­
fore, to present the proper picture at regular intervals in
terms of the currency of the home country.

The owner of a business naturally assumes that the
currency of his own country is the standard of measurement.
To him, a dollar is always a dollar, and a pound a pound,
despite their fluctuations in value. As the exchange rate,

6The common fallacy regarding the value of money
is explained fully in H.W. Sweeney's Stabilized Accounting,
(New York: Harper & Brothers, 1936); and Kenneth MacNeal's
Truth in Accounting, (Philadelphia: University of Penn.
Press, 1939).

7Ibid.
or the value of one currency in terms of another currency, is continuously changing, business men dealing with foreign exchange transactions will encounter various situations, of which the following hypothetical cases are typical.

Case I. Assume that a raw cotton exporter in the United States does business with an importer in England. At the time of a shipment from the United States to England the exchange rate for pound sterling in New York was $4.85. The American exporter drew a 60-day draft against the English importer for £1,000 to cover the cost, profit, and also expenses for shipment. Therefore, he expected to have $4,850.00 in United States currency at the time he is paid. Unfortunately the exchange rate of pound sterling dropped to $4.625 at the maturity time of the draft. When the American exporter converted his £1,000 by the lower rate, he received only $4,625.00 United States dollars, which is $225 less than originally expected.  

Case II. Assume that an American paint manufacturing company established an agency in China for purchasing tung oil. In order to finance local purchases, $2,000.00 in United States currency was converted into $6,779.66 Chinese currency at the rate of U.S.$0.295 per Chinese dollar in February, 1938. A few weeks later, owing to war conditions

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in China, the exchange rate of Chinese dollar in terms of United States currency declined to U.S.$0.265. Purchasing agents of other American paint manufacturing companies in China converted their American money at the later rate which was more favorable. At the rate of U.S.$0.265, $2,000.00 United States currency can be converted to $7,547.15 Chinese currency. Therefore the first American paint manufacturing company incurred a loss of $760.49 in Chinese currency, as compared with the other companies.

Case III. In order to utilize cheap labor or raw materials in China, a factory was established in Shanghai by an American manufacturing company in the United States. The cost of construction of the plant was $100,000 Chinese currency. Since the exchange rate of the Chinese dollar fluctuates all the time, the cost of the plant in China, converted into United States currency and presented in the head office's consolidated balance sheet at the end of each year, will be affected by the changing rate. The average rate of the Chinese dollar for the year 1938 was U.S.$0.2136; for 1939, U.S.$0.1188. The cost of the $100,000 Chinese currency plant in terms of the American currency employed in the consolidated balance sheet of the head office would be $21,360 United States currency for 1938; and $11,880 United States currency for 1939. Stockholders and investors would be

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Case IV. The purpose of banks and brokers who deal in foreign exchange is to make a profit by selling and purchasing foreign currencies. Thus, a ready market is provided for business men who own or need foreign currencies to engage in international transactions. If an American importer receives from a Paris exporter a shipment of silk goods costing 100,000 French francs, he accepts the ninety-day draft drawn by the Paris exporter and purchases at once from a bank 100,000 French francs at U.S.$0.0265 per franc deliverable three months later to cover the transaction. In order to avoid exchange risk, the bank also purchases immediately from the broker 100,000 French francs spot at a favorable rate of U.S.$0.02625, and, instead of depositing the funds in its correspondent bank in Paris, invests the money at the short-term money market in Paris for nineth days at 3 per cent per annum. The short-term loan, together with interest, was collected at the same time the American importer needed the delivery of the 100,000 French francs to pay the exporter in Paris. Therefore, through this transaction, the bank made a profit of $25.00 United States currency from the purchase and sale of the 100,000 French francs and also earned 750 French francs as interest from the short-term investment in Paris.

The cases given above are only four of many kinds of foreign exchange transactions which occur in the market.
every day, but they do provide a general view of the effect
the fluctuating exchange rate has on international business.
Two serious problems are set before business men who deal
with foreign exchange transactions by the fluctuating nature
of exchange rates: first, how to avoid the exchange risk;
second, how to record the transactions logically and system-
atically. The first problem can be solved easily by using
the method of "hedging," the second problem is more compli-
cated and difficult to solve. The following chapters are
devoted to the planning of a scientific foreign exchange
accounting system.
Exporting methods can be divided into two categories, the direct and the indirect, and exporters can be classified according to the methods they pursue.

Manufacturers carrying on their own export business are direct exporters. The simplest method of conducting this kind of business is to distribute the work of exporting on a functional basis among the personnel already engaged in the same type of domestic work. This plan is called the "built-in plan." It utilizes the original structure as it exists and attempts through the instrumentality of an export manager to give foreign trade its proper place and attention in the organization. Sales may be supervised by the sales manager in cooperation with the export manager, or they may be left entirely under the export manager. The treasurer or cashier handles all of the financial arrangements, and the credit man devotes part of

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his time to foreign credits. For bigger enterprises, a separate department is organized to handle all of the functions relating to the export trade, with the exception, generally, of production. The number of divisions and personnel requirements of those divisions are entirely dependent upon the volume of the business. The following divisions are typical: shipping, advertising, accounting, pricing, invoice copying, order copying, translating, etc....

Another way in which the exporting work of a company may be entirely separated from domestic operations is to organize a distinct corporation to handle it. The parent concern then goes about its own affairs, billing the selling company in much the same manner as it does any other customer. This kind of organization has two advantages: first, any possibility of conflict between the domestic and the export interests or personnel is eliminated; and second, overhead can be properly and directly attributed to exports, and profit or loss can be accurately determined for the export business.

Exports through middlemen are indirect exports. The types of middlemen generally engaged in this business are: export commission houses; export merchants; manufacturer's


export agents; and export houses.\(^4\)

(1) Export Commission House. Acting strictly as a commission house, it is the resident representative of foreign buyers and acts as the purchasing agent for them. In case standard goods are ordered, the work of the commission house consists merely in placing the order with the particular manufacturer who produces the articles and in attending to all of the details of exporting. In many cases, however, the foreign buyer designates only in a general way the merchandise he wants and the price limit he is willing to pay. It then becomes the duty of the commission house to shop around and obtain merchandise closest to the description forwarded by the buyer.

(2) Export merchants. The merchant buys merchandise outright on his own account and disposes of it, if possible, at a profit. His transactions are essentially the same as those of a wholesaler or retailer. Commissions are not received, but profit or loss is involved. The merchandise which is exported is usually selected by the merchant, although at times it may be ordered in advance by the buyer. His function is to sell goods, as distinguished from that of the commission house, which performs essentially a buying function.

(3) **Manufacturer's Export Agent.** As a manufacturer's agent, he bears the same relationship to his principal as does a foreign agent. The manufacturer's export agent enters into a contract with a manufacturer whereby he undertakes to sell particular kinds of merchandise in foreign countries. The interests of the principal are fully represented by the agent. For this service, a sales commission is paid.

(4) **Export Houses.** The difference between an export commission house and an export house is that the latter does not conduct all of its business on the commission basis. Furthermore, many export houses engage also in import trade. An important part of the work of export houses consists in financing trade. They usually pay cash against documents for the merchandise which they purchase from manufacturers, and then extend credit to the foreign customer. This procedure constitutes one of the most important risks in foreign trade, and many manufacturers are glad to be relieved of the burden. Export houses usually perform their own freight forwarding service and may even maintain their own steamship line.

Accounting systems for direct exporters and indirect exporters and their middlemen differ, of course, from each other according to the type of organization and volume

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of business. However, when they deal with the problems of foreign exchange, their solutions are almost the same. The foreign exchange problem for exporters originates in pricing. Prices may be quoted in any one of the world's standard currencies, at least that is the case when foreign exchanges are normal and stable. On the principle of making buying easy for the customer, it follows that prices in the buyer's own money, just as correspondence addressed to him in his own language, may appeal strongly to him. Quotations of prices in dollars and cents to a buyer in the United States usually mean more to him than quotations in pounds sterling or in French francs. Quotations in pounds, shillings and pence to buyers in Great Britain, Australia or South Africa, or quotations in francs to customers in France or Belgium, may carry an effective appeal. It was possible before the first World War to quote such prices. Since 1914, however, an element of serious risk has been involved in such quotations, because of the wide and continuous fluctuations in exchange rates. The value of foreign currency in terms of home currency is always changing and unpredictable. Even the best-informed men in the foreign exchange markets can not foretell exactly the future course of exchange with a given country. If prices are named in the currency of another country, they should be liberal enough to cover all future contingencies.

that can be reasonably expected, or due recognition should be
given to the fact that the quotations involve risk and specu-
lation. Nevertheless, profit and loss from foreign exchange
fluctuations are unavoidable. 7

In order to record accurately the profit and loss
cased by foreign exchange fluctuations, a special account
shall be provided for accounting purposes. To illustrate,
assume that a New York manufacturer sells a bill of goods to
a London customer on open account for £1,000. The exchange
rate at the date of sale is $5.10, and the sale is recorded
as follows:

(1) When the goods are shipped:

Goods in Transit.................$5,100
Sales............................... $5,100

(2) When the goods arrive in London and the London
customer accepts the manufacturer's draft:

London Customer...................$5,100
Goods in Transit.................... $5,100

(3) When the London customer pays the New York manufac-
turer's draft for £1,000 and the rate at that time
is $5.15. The manufacturer will sell the £1,000
he received from London at New York foreign exchange
market for $5,150, from which a discrepancy of $50

7Harold S. Benjamin, "Gain or loss on Foreign Ex-
change," The Journal of Accountancy, Vol. 70, September, 1940,
p. 267.
is resulted in his favor through the exchange fluctuation. The entry is:

Cash.............................................$5,150
London Customer..............................$5,100
Exchange Adjustment.........................50

(4) But if the rate at settlement time is $5.07 instead of $5.15, the manufacturer will receive an amount $30 less than he expected as the result of exchange fluctuation, and the entry is:

Cash.............................................$5,070
Exchange Adjustment.........................30
London Customer..............................$5,100

(5) At the close of the fiscal year, if the London customer's account has not matured and if the exchange rate drops to $5.05, the loss on exchange should be recorded as follows:

Exchange Adjustment.........................$50
Reserve for Foreign Exchange Fluctuation$50

This entry shall be reversed at the beginning of the new fiscal year, because the loss is not realized at the year-end. In case the exchange rate at the end of the fiscal period is higher than $5.10, there is

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8 The account title 'Exchange Profit and Loss' is usually employed for 'Exchange Adjustment' cf. Student department, The Journal of Accountancy, December, 1940, p. 539. The writer prefers the latter term because the nature of the entry cf. Chapter 10 of this paper.
an exchange gain resulting from exchange fluctuation, but no entry is necessary for the sake of conservative accounting practice.

In the London customer's account on the New York manufacturer's books, a memorandum of the sterling amount must be made, or this account may be kept in both sterling and dollar in a special two-column ledger as the following:

Illustration I

**Accounts Receivable Ledger**

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<th>Foreign Currency</th>
<th>Rate</th>
<th>U.S.$</th>
</tr>
</thead>
<tbody>
<tr>
<td>1944</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/5</td>
<td>Payment received for invoice No.</td>
<td>£1,000</td>
<td>5.10</td>
<td>$5,100</td>
</tr>
</tbody>
</table>
If the exchange rate is fluctuating violently at the time the sale is made, the New York manufacturer may wish to avoid the exchange risk. He can sell his £1,000 to his bank by signing a selling contract deliverable at the maturity date of his draft drawn on the London customer. There is no exchange of money - simply a contract which will involve an exchange of money later when he receives the payment from his customer. This procedure is usually called "hedging." An accounting process for recording hedging can be illustrated as follows:

(1) When the goods are shipped and a draft is drawn on the London purchaser, the manufacturer sells his £1,000 to his bank deliverable 60 days later. The exchange rate is $5.10, and the entry is:

\[
\begin{align*}
\text{Due from the Bank} & \quad \text{\$}5,100 \\
\text{Exchange Future Sold} & \quad \text{\$}5,100
\end{align*}
\]

(2) When payment is received, the New York manufacturer delivers the sterling to the bank, and, in return, he receives $5,100. The selling contract is cancelled, and the entry is:

\[
\begin{align*}
\text{Cash} & \quad \text{\$}5,100 \\
\text{Exchange Future Sold} & \quad 5,100 \\
\text{London Customer} & \quad \text{\$}5,100 \\
\text{Due from the Bank} & \quad 5,100
\end{align*}
\]

---

Therefore, the transaction is settled without paying any attention to the current exchange rate of pound sterling, and there is no need to adjust exchange profit and loss at the close of the fiscal period, since it is properly hedged.

The Sales Journal and Cash Receipts Book of an export business are more complicated than those used only for domestic sales. In the Sales Journal, there are columns for the following headings:

1. Date
2. Invoice number
3. Name of the customer
4. Address
5. Terms
6. Ledger number
7. Amount of foreign currency
8. Rate of exchange
9. United States currency

In the Cash Receipts Book, there are ten columns with the headings as follows:

1. Amount of remittance
2. Date
3. Invoice number
4. Name of the customer
5. Folio
6. Discount
7. Amount of remittance realized in United States currency
8. Rate of exchange
9. Profit on exchange (United States currency)
10. Loss on exchange (United States currency)

These headings are illustrated on the next page.
### Illustration II

**Sales Journal**

<table>
<thead>
<tr>
<th>Invoice Date</th>
<th>Number</th>
<th>Customer's Name</th>
<th>Address</th>
<th>Terms</th>
<th>L.F. Currency</th>
<th>Amount of Foreign Currency</th>
<th>United States Currency</th>
<th>Rate</th>
<th>Currency</th>
</tr>
</thead>
</table>

### Illustration III

**Cash Receipts Book**

<table>
<thead>
<tr>
<th>Remittance (Foreign Currency) Date</th>
<th>Number</th>
<th>Customer's Name</th>
<th>L.F. Discount</th>
<th>Realized Rate Exchange</th>
<th>Profit on Currency</th>
<th>Loss on Currency</th>
</tr>
</thead>
</table>
Importers

Importers can also be classified, just as exporters, into two general categories: direct importers and indirect importers.

Under the category of direct importers, import departments of the "built-in" type are especially common. Among importing manufacturers there is rarely an import department of any type distinct from the purchasing division. When orders are placed with foreign middlemen or producers, the purchasing division meets no difficulty. Technical details associated with importing are generally attended to by customs brokers, and the traffic department handles the physical movement of the merchandise from the port of entry. The organization of the business is thus fitted to procure merchandise from any and all sources, foreign as well as domestic. In some instances, raw materials and semi-finished manufactured goods are obtainable only from abroad, and then the entire purchasing function consists of importing. When either foreign or domestic sources are tapped, the selection of either, or the concurrent use of both, are very closely related. This renders unnecessary the organization of a special import purchasing department. But large department stores and retail specialty shops usually have a centralized import department, because the ramifications of their business are great and the technical details of customs clearance are in themselves sufficient to warrant the establishment of an
import department.

Imports through the hands of middlemen are indirect imports. The types of middlemen now generally included are: (1) import commission houses; (2) import merchants; (3) import brokers; and (4) indent houses.¹⁰

(1) **Import Commission Houses.** The import commission house takes care of the interests of its customers in the same manner as described for the export commission house. Moreover, the import commission house receives consignments from foreign producers by whom they are paid a selling commission when goods are sold.

(2) **Import Merchants.** The import merchant buys for his own account; he performs the same functions as the domestic wholesaler. He assumes the whole merchandising risk and provides quick deliveries of merchandise. Import merchants are particularly important in the United States, especially in food products such as tea and coffee, and in raw materials such as wool and silk.

(3) **Import Broker.** An import broker is one who buys foreign goods, not for his own account, but for the account of another. He usually receives a stipulated fee from the party who engages him.

(4) **Indent Houses.** The indent house is an im-

---
porting concern which imports only upon orders received from purchasers in its own country.

"An indent is a pro forma order, or specification, sent abroad for price quotation....
"Their profit results from: (a) ability to buy advantageously as a result of their organization and experience; (b) ability to secure lower transportation costs; and (c) profit on exchange."11

If all the purchases of an American importer are billed in American dollars, there is no need for him to employ foreign exchange accounting because the foreign exporter will make the gain or bear the loss resulting from any fluctuation in exchange rates. But many times the importers are billed in terms of foreign currency and the exchange risk is, therefore, shifted to the side of the importers. Their method of dealing with foreign exchange problems is similar to the exporter's, but the effects of the transactions is just the opposite direction. For example, assume that a San Francisco department store purchases a shipment of silk goods from a Shanghai exporter who bills to the department store for $6,779.66 Chinese currency. The rate on the date of the transaction is U.S.$0.295, but the rate drops to U.S.$0.292 on the date of settlement. The entry on the books of the San Francisco department store will be:

(1) When the shipment arrives and the importer accepts

11Bureau of Foreign and Domestic Commerce, Export and Import Practice, p. 158.
the draft drawn by the Shanghai exporter, the following entry is passed to record the purchase of silk goods for $6,779.66 Chinese currency, which is equivalent of $2,000 United States currency at the rate of U.S.$0.295.

Purchases.........................$2,000.00

Shanghai Exporter............... $2,000.00

(2) On the date of settlement, the rate is U.S.$0.292. The San Francisco department store earns a profit of $20.34, since $1,979.66 United States is equivalent to $6,779.66 Chinese currency at the rate of U.S.$0.292. The entry will be:

Shanghai Exporter................ $2,000.00

Cash................................. $1,979.66

Exchange Adjustment.............. 20.34

(3) But, if the rate is U.S.$0.297 at the date of settlement, the payment of $6,779.66 Chinese currency will cost $2,013.56 United States currency, the entry to record the settlement will be:

Shanghai Exporter................ $2,000.00

Exchange Adjustment.............. 13.56

Cash................................. $2,013.56

(4) If the end of the importer's fiscal year occurs before maturity of the obligation, and if the exchange rate of Chinese dollars is unfavorable, an adjusting entry should be made to record the possible loss on
exchange. Assume that the rate is U.S.$0.298, the loss is $20.33, and the entry will be:

\[
\begin{align*}
\text{Exchange Adjustment} & \quad \text{\$20.33} \\
\text{Reserve for Foreign Exchange Fluctuation} & \quad \text{\$20.33}
\end{align*}
\]

This entry should be reversed at the beginning of the new fiscal year because the loss is not realized. If the exchange rate is favorable at the close of the fiscal year and a profit on exchange is earned, no adjusting entry is needed.

On the San Francisco department store's books, a memorandum of the amount of Chinese currency must be made in the Shanghai exporter's account, or this account may be kept in both Chinese and American dollars in a two-column ledger sheet.

If the San Francisco department store wants to be protected from the speculative risks from exchange fluctuations, the store may, at the time of purchasing the goods, buy future exchange on Shanghai. The entries to record future purchases are as follows:

(1) At the time of the purchase of future $5,900 Chinese currency at the rate of U.S.$0.295 to cover the exchange risk.

\[
\begin{align*}
\text{Exchange Futures Purchased} & \quad \text{\$2,000} \\
\text{Due to the Bank} & \quad \text{\$2,000}
\end{align*}
\]
(2) At the time of settlement, the department store pays his bank $2,000 United States currency, and, in return, obtains a draft of $5,900 Chinese currency on Shanghai, which will be mailed to the Shanghai exporter. The entry will be:

Shanghai Exporter.................. $2,000
Due to the Bank..................... 2,000

Cash................................. $2,000
Exchange Futures Purchased...... 2,000
CHAPTER III

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN AGENCIES

The preceding chapter deals only with foreign traders who are located in their own country. Chapters III to VI are devoted to the discussion of foreign exchange accounting for foreign branches. When foreign branches are established in foreign countries with the head office in the home country, they encounter three accounting problems which were not discussed in the preceding chapter. The three problems are: (1) inter-office transactions; (2) the treatment of property in foreign countries; and (3) the consolidation of statements. These problems can be examined systematically according to the nature and organization of different kinds of branches.

In order to develop international trade and an intimate relationship with customers or producers in foreign countries, the establishment of branch houses or permanent resident representatives of the home office in foreign markets is very popular.

There are three notable advantages of establishing branches in foreign markets: first the branch office has but
one interest to serve. The manager is not interested in any merchandise other than his own, and his success depends on the sale of that merchandise. He should be able, therefore, to increase his business greatly with those local customers who have already been secured; and he ought to be able, because he is on the ground, to secure many new customers.

Second, if the stock of merchandise is carried in the local warehouse, trade may be greatly increased because of prompt deliveries. Delays in shipment from the overseas factory are avoided. A third advantage is the continual presence in the foreign market of an authorized representative of the home office, who is thus able to watch all correspondence closely and to settle disputes that from time to time arise even in the best conducted businesses. Also, he can take over shipments that are refused and dispose of them to the best advantage, guarding the home office against loss.

But, on the other hand, there are disadvantages, too. If the previous trade of the foreign market has been handled by large and important local houses, they are likely to be antagonized by the fact of the permanent local establishment of a branch of the manufacturer or exporter. The foreign branch immediately enters direct competition with long established local merchants who are much more familiar with local conditions and credits than the manager of a branch

———

of a foreign business can be. The newly established branch has to fight for its existence. In the first months or years, heavy losses may, therefore, be expected from the effort to put such a foreign branch on its feet. Furthermore, the selecting and training of staffs for foreign branches is another problem, because the success and profit in the establishment of foreign branches depend primarily on the management of the branch and only to a lesser extent on the market itself.

The principal types of branches found in foreign trade are: (1) the foreign buying and selling agency; (2) the foreign purchase and sales branch; (3) the foreign warehouse branch or foreign branch manufacturing plant; and (4) the foreign subsidiary.\(^2\)

A permanent foreign buying or selling agency is the smallest unit of which a foreign branch may consist, and it is usually distinguished from a regular branch by the fact that an agency acts merely as a local agent under the direct supervision of officers of the home office.\(^3\) On the other hand, a branch is an organization which is granted the power


\(^3\)A permanent foreign agency is different from a foreign agent, 'who undertakes to sell in foreign markets the goods usually produced by several manufacturers. The agent in this way takes the place of the export department or export manager. He is paid on a commission basis by the manufacturers who employ him. The advantages are found mainly in the saving resulting from the fact that where there are no sales there are no expenses.' Cf. R. N. Montgomery, *Financial Handbook*, Second Edition, p. 1463.
to engage in transactions as an independent business unit. An agency that operates solely as a local sales agent under the direction of a home office generally carries no stock other than samples of the lines that are offered for sale. Samples as well as advertising materials are supplied by the home office. The agency is also allowed a certain working fund that may be used for the payment of expenses when these can be more conveniently settled through the agency. Orders for merchandise obtained by the agency are sent to the home office for approval. If the terms of sale, price, and credit are acceptable, the home office fills the orders and makes shipment to customers. The home office bears the responsibility for maintaining the accounts arising out of sales, billing the customers, and making collections. Costs of operating the agency, other than those paid by the agency from its working fund, are met by the home office.

Most of the agencies require no complete set of books, since the home office is in charge of both billings and collections. The manager's salary, sales commissions, and bonus are paid directly by the home office in home currency. Rent, office supplies, telephone and telegraph, electricity, and other local expenses are paid in foreign currency through the foreign agency working fund, which will be replenished and restored to its original balance whenever it runs low. A record to summarize working fund receipts and disbursements, therefore, is necessary. A summary of the disbursements
accompanied by supporting evidence in the form of paid vouchers should be sent to the home office. At the end of the fiscal period, when the books are closed, the balance of the agency's working funds should be converted at the current rate, and any difference between the value thus determined and the balance of the agency working fund account on the home office's books should be taken up as a debit or a credit to the Exchange Adjustment account.

Agency transactions, therefore, are all carried in the home office books; they may be recorded in the income and expense accounts used by the home office for its own transactions if there is no desire on the part of the home office to summarize separately the operations of each agency. However, in order to determine the degree of success or failure resulting from the operations of each agency, it is advisable for the home office to maintain separate income and expense accounts for each agency. In addition to separate accounts, a supplementary record of the cost of goods sold by each sales unit is kept. At the end of the fiscal period this record provides the data for the entries charging each agency with the cost of goods identified with its respective sales.

The above procedure can be clarified by the following illustration. Assume that an American trading company in New York establishes a sales agency in London. A foreign agency working fund of five hundred pounds is set up for the new agency. Income and expenses are identified with
the agency responsible for such items, and the operating results for the agency, as well as for the home office, are determined at the end of every month. Agency transactions and the respective entries to record the transactions on the books of the home office are listed as follows:

Agency transactions:
(1) Receipt of working fund from home office on June 1, when the agency was established, £500.
(2) Orders, totaled $6,500, submitted by agency during the month of June, approved and filled by home office.
(3) Collections of $4,500 made by home office on agency sales in June.
(4) Disbursements by home office on behalf of agency:

Agency manager's salary......$350
Sales commissions............... 650
Bonus.......................... 100
Agency advertising and supplies............... 400

Total $1,500

(5) Replenishment of working fund by home office at the end of June, paid expense vouchers being submitted by the agency as follows:

Rent............................. £40
Office supplies................... 5
Telephone and telegraph....... 15
Electricity....................... 5
Miscellaneous expenses....... 45
Office clerks.................... 60

Total £170
(6) Entries summarizing agency transactions:

(a) Cost of goods identified with agency sales, $3,500.

(b) Agency advertising supplies used during June, $100.

Corresponding entries in home office's books:

(1) On June 1, a draft of £500 is sent from the home office, purchased at the rate of $5.10, to the London agency.

   London Agency Working Fund............$2,550
   Cash........................................$2,550

(2) Orders submitted by London agency are recorded in the agency's sales account in home office's books.

   Accounts Receivable.....................$6,500
   London Agency Sales.....................$6,500

(3) Collections made by home office on London agency sales in June is entered to cash account.

   Cash........................................$4,500
   Accounts Receivable.....................$4,500

(4) Disbursements by home office on behalf of London agency for the month of June are charged to the agency's expense accounts.

   London Agency Salary....................$350
   London Agency Commission.............$650
   London Agency Bonus....................100
   London Agency Advertising and Supplies..................400
   Cash........................................$1,500
(5) Replenishment of working fund by home office - the total amount of working fund to be replenished is $170 which is supported by vouchers submitted by the London agency. The exchange rate for sterling is $5.00 at the end of June. The equivalent amount of United States currency for $170, at the rate of $5.00, is $850. A draft for $170 is sent to the London agency; its cost is paid from the home office cash account, but charged to various expense accounts of the London agency.

| London Agency Rent                | $200  |
| London Agency Office Supplies     | 25    |
| London Agency Telephone and      |       |
| Telegraph                        | 75    |
| London Agency Electricity        | 25    |
| London Agency Miscellaneous      | 225   |
| London Agency Salary             | 300   |
| Cash                             |       |
|                                  | $850  |

(6) Entries for summarizing London agency transactions for the month of June:

(a) To record the cost of goods sold for London agency.

   London Agency Cost of Goods Sold...$3,500

   Merchandise Shipments - London Agency...$3,500

(b) To record the advertising supplies used by London agency.

   London Agency Advertising Supplies Used...$100

   London Agency Advertising Supplies $100
(c) To transfer London agency sales to its profit and loss account.

   London Agency Sales................. $6,500
   London Agency Profit and Loss.... $6,500

(d) To transfer London agency's expenses during the month of June to the profit and loss account.

   London Agency Profit and Loss..... $5,550

   London Agency Cost of Goods Sold $3,500
   London Agency Salary................ 650
   London Agency Commissions........... 650
   London Agency Bonus.................. 100
   London Agency Advertising Supplies........................................ 100
   London Agency Rent.................. 200
   London Agency Office Supplies...... 25
   London Agency Telephone and Telegraph........................................ 75
   London Agency Electricity........... 25
   London Agency Miscellaneous Expenses........................................ 225

(e) To transfer the loss on exchange the profit and loss account - the London Agency Working Fund of £500 is, according to the current rate $5.00 at the end of June, the equivalent of $2,550. But its original cost is $2,550; therefore, a loss of $50 is incurred on exchange.

   London Agency Profit and Loss..... $50
   Reserve for Exchange Fluctuation $50

(f) To transfer the profit made in June by London agency to the profit and loss summary account.

   London Agency Profit and Loss..... $900
   Profit and Loss Summary............ $900
It will be noted in the above illustration that the cost of the goods sold by the agency is recorded by a debit to Agency Cost of Goods Sold and a credit to merchandise Shipments - London Agency. The balance of the latter account is subtracted from the sum of the home office beginning inventory and purchases to determine the merchandise available for home office sales. The home office ending inventory, when subtracted from merchandise available for sale as thus determined, gives the cost of goods identified with home office sales. As regards the entries summarizing agency transactions under (6), agency income and expense accounts are closed into an agency summarizing account to determine the agency profit and loss. The balance of the summary account is transferred to the general profit and loss summary account in which the profit or loss resulting from home office activities has already been determined. The latter account then shows the total net profit or loss from the combined operations of the home office and its agency. The adjusting entry (6)-(e) for the loss of $50 on exchange fluctuations is a fictitious one because it is not realized, and, therefore, it will be reversed at the beginning of July as follows:

Reserve for Exchange Fluctuation.... $50
Surplus......................... $50

The illustration given above is based on the assumption that all the sales of the London agency are billed in United States currency so that no conversion problems have
arisen, except for working funds. In the books of the home office, a separate London agency sales book is kept, and the accounts receivable for the London agency may be kept in a separate subsidiary ledger. Sales, returns and allowances, and remittances are all on a dollar basis, and no exchange adjustments will appear. The exchange problem arises, however, if sales are billed in the foreign currency. The easiest way to deal with it is to keep a separate set of books of original entry for foreign business. The sales book will have a foreign amount column and a dollar amount column. Entries will be made for the foreign billing and for the dollar value thereof at the time of sale. When postings are made to the subsidiary accounts receivable ledger, the foreign amount will be entered in an inner, or memorandum, column, as in the example in Chapter II. A foreign accounts receivable controlling account will be kept in the general ledger, charged in an inner column with the foreign amount of sales, and in an outer column with the dollar amount. This general ledger account will thus control the subsidiary ledger both in foreign and in dollar amounts. Both the total of the foreign currency column and the total of the dollar column of the sales book will be posted to the credit of the foreign agency sales account which also provides columns for both currencies.

A foreign returned sales and allowances book may be
kept with both foreign currency column and dollar column; the detail in both currencies will be posted to the credit of the individual accounts of the subsidiary ledger; both column totals will also be posted to the credit of the foreign accounts receivable controlling account, and to the debit of the foreign agency returned sales and allowances account.

The Cash Receipts Book, like that of the importers discussed in Chapter II, will include the following columns:

1. Date  
2. Invoice number  
3. Name of customer  
4. Explanation  
5. Foreign amount  
6. Discounts and allowances  
7. Dollar amount  
8. Loss on exchange  
9. Profit on exchange  
10. Rate  
11. United States currency realized

The use of the Cash Receipts Book can be illustrated by the following example. Assume that an American trading company sells, through its own London agency, to an English customer an invoice of £1,000 at a time when the exchange rate is $5.00. The English customer obtains an allowance of £10 at the time when the sale is made. The customer's account in the subsidiary ledger will appear as follows:

<table>
<thead>
<tr>
<th>English Customer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sale</strong></td>
</tr>
</tbody>
</table>
### Illustration IV

**Cash Receipts Book**

<table>
<thead>
<tr>
<th>Date</th>
<th>Invoice Number</th>
<th>Name</th>
<th>Explanation</th>
<th>Foreign Amount</th>
<th>Foreign Allowances</th>
<th>Dollar Amount</th>
<th>Dollar Rate</th>
<th>Loss on Exchange</th>
<th>Profit on Exchange</th>
<th>United States Currency Realized</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>1/15</td>
<td>English customer through London agency</td>
<td>£1,000</td>
<td>£10</td>
<td>$4,950</td>
<td>5.10</td>
<td>$99</td>
<td>$5,049</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


The balance of the English customer's account is £990 and is represented by a dollar balance of $4,950. The account is settled a month later by a draft of £990, which is sold by the American trading company to its own bank at the rate of $5.10, or for $5,049. The difference between $4,950 and $5,049 is $99, which is the profit made on exchange fluctuation. This entry is illustrated on the preceding page. The entries in the foreign amount and dollar amount columns will be posted to the credit of the English customer's account, thus balancing it. The totals of these two columns will be posted to the foreign accounts receivable controlling account in the general ledger. The totals of the exchange columns will be posted to Exchange Adjustment account, and the total of the United States currency realized column will be charged to the bank account as a bank deposit. The entry can be shown clearly by the following journal entry, disregarding the equivalent in pounds sterling.

Deposit in the Bank.................$5,049
London Customer.................... $4,950
Exchange Adjustment............... 99

At the end of the fiscal period, the sterling balance of the foreign accounts receivable controlling account may be converted into United States dollars at the current rate of exchange, and if there is any loss incurred through exchange fluctuation, it will be taken up in the Reserve for Exchange Fluctuation account, just as was described in Chapter II for.
importers. The Reserve for Exchange Fluctuation account will be reversed at the beginning of the next fiscal period, since the loss is not realized. If a profit resulted from exchange fluctuation in this case, no adjusting entry is necessary.

The above illustrations are all for the foreign sales agency, but the same method can be followed by an American trading company which operates a foreign purchasing agency. All purchases are billed to and paid by the home office. If all invoices are paid in terms of foreign currency, a foreign purchase book, returned purchases and allowances book, cash disbursements book, accounts payable account, and subsidiary accounts payable ledger would be kept.
CHAPTER IV

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN BRANCHES

The establishment of a branch in a foreign market before any business has been secured will occur, probably, only in the case of very large concerns, which discover after thorough investigation that the market is a large and important one for their goods and that the opportunities for success are present. Usually, however, a manufacturer does not even consider the establishment of a foreign branch of any description until his trade in a given market has been pretty well established and seems to promise favorable development through more intensive cultivation, or until limitations and handicaps develop in the other ways of cultivating that particular market which apparently are only to be overcome through direct representation of the manufacturer's own branch office or plant.1

The foreign branch differs from a foreign agency, in that it is operated as a separate business unit but is ultimately subject to control by the home office. The degree of self-management and independence granted to the

1B. O. Hough, The Export Executive, pp. 228-9
branch in the exercise of the functions assigned to it is a matter of expediency to be determined by the home office. General policies and standards adopted by the business are usually applied to all of the branches. Outside of this realm, however, the branch manager may be given complete authority, the efficiency of his management and control being judged on the basis of the branch statement of profit and loss over a period of time. A branch is usually supplied by the home office with cash and merchandise and such other assets as it may need. The merchandise stock from the home office may be supplemented by branch purchases from outsiders to satisfy certain local demands for merchandise not available from the home office. The branch is ordinarily empowered to bill its customers and to make collections of receivables. Collections made by the branch office are deposited in its own bank account. The bank balance is drawn upon in making payment for purchases of merchandise and services. An independent accounting department is organized to take charge of a whole set of books for recording all the activities of the branch office in foreign currency. ²

The accounting procedure for foreign branches would be a simple one, if the exchange rate of the foreign currency never varied, for in that case a certain number of pounds,

francs, etc. would always represent the same amount when expressed in American dollars. But there is no such fixed exchange rate. The accounting problem becomes complicated, because profits earned in foreign currency have to be distributed among shareholder in domestic currency; and because the working capital of the undertaking is, for the time being, invested in assets which are only realizable in foreign currency. Furthermore, the rate of exchange fluctuates frequently and sometimes varies within very considerable limits. The problem, therefore, is one that requires the most careful consideration, if it is to be treated so that the accounts may accurately show the real position of affairs.

There are, in general, two complicated problems with which an accountant has to deal when he designs an accounting system for a foreign branch office:\(^3\)

(1) The inter-office transactions, which include:

(a) the transfer of merchandise or cash from home office to foreign branch, or from foreign branch to home office,

(b) any other transactions which are recorded in one currency on one set of books and which must be recorded at an equivalent value in the other currency on an other set of books.

---

(2) The consolidation of statements, which includes:

(a) the branch profit, recorded and computed on the branch books in the foreign currency, which has to be converted and recomputed into home currency and entered on the home office books,

(b) the branch profit and loss statement which has to be consolidated with the home office profit and loss statement,

(c) the branch balance sheet which must be consolidated with the home office balance sheet.

The first problem can be solved by the use of a two-column ledger on which both the amount in foreign currency and home currency are recorded. Special accounts for remittance can be established for the purpose of separating remittance transactions from other inter-office transactions.4 When the home office sends a draft in sterling to its London branch, the home office debits Remittances to the London Branch account, instead of debiting the London Branch Current account; and the London branch credits Remittances from the Home Office account, instead of crediting the Home Office Current account. These entries are made so that reciprocal accounts on the two books will show the value, in both currencies, of funds transferred from the home office to the

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London branch. At the close of the fiscal period, the dollar balance of the Remittances to the London Branch account on the home office's books will be the real cost or equivalent of the sterling balance of the Remittances from the Home Office account on the London branch's books; there will be no need to employ any exchange rate for conversion.

Whenever an inter-office transfer of funds or merchandise is made, the office which remits or sends the money or merchandise will send the receiving office a "Disbursement Voucher" or an invoice, which serves as an advice and also as an evidence of entry for the accounting department. The form of a "Disbursement Voucher" is shown below.

Illustration V

Disbursement Voucher

X. Y. Z. Company
New York

Date.............

Head Office) account has been (dr. with (dollars
Branch) account has been (cr. with (pounds

...............being the equivalent of .............
at the rate.............for..................................
as per your advice dated..................................

After the receiving office enters the transaction accordingly, the receiving office is also required to send an advice, by
using the same form, to the disbursing office as confirmation. By adopting this system, the possibility of making mistakes on inter-office transactions is completely avoided, especially for a head office with several foreign branches.

The second problem is more complicated than the first. It would be a great mistake just to convert the profit or loss from the London branch statements into dollars and to transfer it to the general profit and loss account of the home office, because the amount of profit or loss in sterling represents only the profit or loss of the London branch's operation during that period, and it does not include any changes incurred from foreign exchange fluctuations. From the viewpoint of the home office, the sterling amount, instead of being a definite expression of value, is only the medium temporarily employed at the London branch for recording the transactions in such a form that they may afterwards be considered upon their respective merits by the home office when the sterling trial balance is sent home or when the consolidated statements are being prepared. At the close of each fiscal period, all the items on the London branch's trial balance, profit and loss statement, and balance sheet are to be converted into American dollars in order to combine them with the respective statements of the home office.

^The term 'to convert' or 'conversion' is the general accepted term used in the accounting field, but Edwin F. Chinlund prefers the word 'translation,' cf. "Translation of Foreign Currencies," The Journal of Accountancy, Vol. 62, August, 1936, pp. 118-121.
Because no uniform rate can be employed for the purpose of consolidation, there arises the problem of selecting various rates for the conversion of various items.

The necessity for careful choice of conversion rates may be suggested if the branch information is to be converted at the close of a year, at the beginning of which the exchange rate was $5.00, during which the average rate was $5.05, and at the close of which the rate was $5.10. If the average rate is used as a uniform rate for conversion, then the London branch's property which is purchased at the beginning of the year at the rate of $5.00 will be overstated. On the other hand, its current assets will be understated. The local current liabilities are stated at a dollar amount less than the actual amount that would have to be sent out from home in order to cancel them. This method is also equally misleading in connection with the trading and profit and loss accounts, because the aggregate of the transactions representing income and expenditure during the current period is undervalued. It will thus be seen that, by use of this uniform rate, fixed assets are overstated, current assets understated, fixed liabilities overstated, and current liabilities understated. In some circumstances it may happen that the various items of assets and liabilities so balance each other that the aggregate result is approximately correct, but the conversion of each individual item is quite inaccurate.
Various rates, therefore, should be adopted for the conversion of various accounts or items on the statements of the branch office for the purpose of consolidation. The most acceptable rules for conversion are listed as follows.6

(1) **Fixed Assets.** Fixed assets should be converted at the rate at the time of purchase, and if the purchase is made in foreign currency then it should be converted at the rate prevailing at the time of payment. This should be done so that profits and surplus may not be affected by valuing fixed assets at market prices, whether expressed in one currency or another. If fixed assets are converted at the current rate of exchange, which is bound to be higher or lower than the rates prevailing at the dates of acquisition of the fixed assets, those assets would be written up or down in contravention of the general accounting principle.

(2) **Current Assets.**7 Cash, accounts receivable, and notes receivable accounts, and other miscellaneous current assets should be converted at the current rate at the

---


date of the balance sheet, because this rate gives the present value of the assets at the date of the balance sheet and because this rate is also the best index of the probable net realizable value of assets to converted into cash within a short period of time.

(3) **Inventories.** According to general accounting rules, inventories should be valued at market or cost, whichever is lower, in home currency. But when the question of foreign exchange is taken into consideration, the application of the standard rule is modified by different circumstances:

(a) **Merchandise Inventories.** This is the kind of inventory which is expected to be sold in a foreign market and which is valued on the foreign branch office's balance sheet by the standard rule of market or cost, whichever is lower, in foreign currency. Hence, it is expected to be converted into cash soon; it is a current asset and should be converted at the current rate at the date of the balance sheet. But there are special cases; for example, at the beginning of the year, when the exchange rate of one French franc is U.S.$0.15, a New York trading company sends over to its Paris branch $2,000 in merchandise. Therefore, the merchandise is recorded
as 13,333.33 French francs on the books of the branch office. Only a few months later, owing to the action of the French government in depreciating the value of the franc, the exchange rate of one French franc drops to only U.S.$0.05. The market price of the merchandise in Paris would undoubtedly have been increased since the fall of the exchange rate, and it would be unreasonable to apply the rule of 'market or cost whichever is lower' on this merchandise, because the merchandise could be replaced only at a much higher price. If the current rate is used, the equivalent of 13,333.33 French francs is only $666.67. In this case, therefore, the original dollar cost, $2,000, may be considered as the cost price for purposes of inventory.

(b) Raw Material Inventories. This is the kind of inventory which is expected to be used for the manufacture of new products. The importance of this kind of inventory is its original cost. Therefore, raw material inventory, which is shipped from the home office, is always converted at the dollar balance of the reciprocal account on the home office's books. But local purchases from outsiders are converted at an average rate for the period.
(c) **Initial Inventories.** Since the initial inventory is also the closing inventory of the last period, it should appear at the same dollar value in the two statements. The initial inventory and the closing inventory of the last period are always converted at the same rate. Therefore, the initial inventory should be converted at the rate prevailing at the start of the period, and the final inventory at the current rate at the end of the period.

(4) **Fixed Liabilities.** Bonds payable and other long-term liabilities should be converted at the rate of exchange prevailing when the liability was actually contracted. Therefore, unamortized discounts and premiums on bonds payable should be at the same rate.

(5) **Current Liabilities.** Current liabilities are subject to discharge in the ordinary course of business; the current rate, therefore, should be used for conversion so that the dollar equivalent would reflect the necessary remittance required to discharge such liabilities, at the date of the balance sheet.

(6) **Reserves.** Reserves should be converted according to the nature of each reserve account; for instance, liability reserves should be converted at the same rate that is used to convert the liabilities of the same class, and valuation reserves should be converted
at the same rate that is used to convert the asset
for which the particular reserve is set up. Reserve
for Bad Debts, just like Accounts Receivable, should
be converted at the current rate. The Reserve for
Depreciation should be converted at the same rate
that is used to convert the fixed asset for which
the reserve is set up.

(7) Accrued and Deferred Items. These items are mostly
current in nature; they should be converted at the
current rate at the date of the balance sheet. But
objections may arise owing to the fact that these
items are usually expenses and incomes which should
be converted at the average rate, just as the con­
version of ordinary expense and income accounts. It
seems very difficult to decide which is right. But
as these items are usually small and relative insig­
nificant, they can be converted at the current rate
even though the expense and income items are converted
at the average rate.

8A recent study of reports of companies listed on
the New York Exchange indicates that prepaid expenses and
defered charges are general shown as noncurrent assets......
If the prepaid expenses and deferred charges fulfill the re­
quirements of a current asset in that they will be absorbed
within one year from the date of the balance sheet, and if
the balance sheet is that of a going concern, the author does
not believe it does violence to common sense to treat such
items as current assets if it is clearly set forth that they
are prepaid expenses or deferred charges." cf. R. H.
Montgomery, Auditing, (Sixth Edition; New York; The Ronald
(8) **Income and Expenses.** A different rate should be used in different cases for the conversion of expenses and income.

(a) If the branch office transfers to the home office its current income upon receipt and obtains funds from the home office for the payment of major expenses during the accounting period, the profit of the branch office is currently converted into home currency and transferred to the home office. In this case, it is logical to use an average rate for the conversion of expenses and income. An average rate of exchange can be derived in three ways:

(i) by averaging the daily rates or monthly rates for the year;

(ii) by dividing the balance of Remittances to Home Office account (in foreign currency) on the branch's books into the balance of Remittances from Branch Office account (in home currency) on the home office's books; and

(iii) by using a weighted average which is computed in such a way that the rates prevailing during busy seasons are given more importance than the rates prevailing during inactive seasons.
(b) If the branch office keeps its profits made during the accounting period and if the profits remain in its current assets accounts, the rate used for the conversion of expenses and income should be the current rate at the date of the balance sheet. Because the current assets in which the profits are invested are converted at the current rate, it is consistent to use the same rate to convert expenses and income, which are the main items in the profit and loss statement.

(9) Reciprocal Accounts. There is no need for conversion, because they are all offset by the dollar balances of respective accounts on the home office books:

(a) Remittances from the Home Office is the equivalent of the dollar balance of the home office account, Remittances to Branch Office account.

(b) Remittances to the Home Office is the equivalent of the dollar balance of the home office account, Remittances from Branch Office account.

(c) Merchandise from the Home Office is the equivalent of the dollar balance of the home office account, Shipments to Branch Office.

(d) Home Office Current account is the equivalent of the dollar balance of the home office account, Branch Office Current account.
An illustration of the foregoing methods of recording the transactions of a foreign branch seems necessary, because it will help to understand the detailed procedure. Assume that cotton export company in New Orleans opens a branch in London, and on the London branch books there are the following transactions:

(1) The London branch, at the opening date, receives from the home office in New Orleans a draft of £1,000 which is purchased at $4.95.

(2) The London branch receives another draft of $2,450 in United States currency. The branch sells the draft to its own bank in London at the current rate of $4.90, and deposits the proceeds £500 in its account.

(3) The London branch receives from the home office a shipment of cotton of $50,500, and the rate at the time of shipment is $5.05; therefore, £10,000 is its sterling cost.

(4) Purchases of merchandise made by London branch from local market, on account, cost £2,000.

(5) Purchases of fixed assets for £1,000 are paid in cash; at the time of payment the rate is $4.99.

(6) Sales made by branch on account £16,000.

(7) Collections on account, £13,000.

(8) Accounts Payable paid, £1,000.

(9) Expenses for the branch, £3,000.
(10) Estimated depreciation for the period is £100, and estimated bad debts, £100.

(11) The home office receives from the branch a draft of £4,000, which is sold by the home office to its own bank in New Orleans at the rate of $4.95, realizing $19,800.

(12) The home office receives from the branch a draft of $20,200 United States currency, which is purchased by the branch with £4,000 at the rate of $5.05.

*On the books of the London branch, the above transactions are recorded as follows:*

(1) To record the receipt of remittance £1,000 from home office:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>£1,000</td>
</tr>
<tr>
<td>Remittances from Home Office</td>
<td>£1,000</td>
</tr>
</tbody>
</table>

(2) To record the transfer from the home office of $2,450, which is sold for £500 at $4.90:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>£500</td>
</tr>
<tr>
<td>Remittances from Home Office</td>
<td>£500</td>
</tr>
</tbody>
</table>

(3) To record the receipt of the $50,500 worth of cotton from the home office, converted at the current rate of $5.05:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise from Home Office</td>
<td>£10,000</td>
</tr>
<tr>
<td>Home Office Current</td>
<td>£10,000</td>
</tr>
</tbody>
</table>

(4) To record the local purchases of merchandise:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases</td>
<td>£2,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>£2,000</td>
</tr>
</tbody>
</table>
(5) To record the purchases of fixed assets:

Fixed Assets.......................... £1,000
Cash...................................... £1,000

(6) To record the sales of £16,000, on account:

Accounts Receivable................... £16,000
Sales...................................... £16,000

(7) To record accounts receivable collected:

Cash...................................... £13,000
Accounts Receivable................... £13,000

(8) To record accounts payable paid:

Accounts Payable........................ £1,000
Cash...................................... £1,000

(9) To record expenses paid:

Expenses................................. £3,000
Cash...................................... £3,000

(10) To record reserves for depreciation and bad debts:

Expenses................................. £200
Reserve for Depreciation.............. £100
Reserve for Bad Debts............... £100

(11) To record the transfer of £4,000 to home office at
the rate of $4.95:

Remittances to Home Office......... £4,000
Cash...................................... £4,000

(12) To record the transfer of another £4,000 to home
office at the time the rate is $5.05:

Remittances to Home Office......... £4,000
Cash...................................... £4,000
On the other hand, on the books of the home office, there are corresponding entries for Number 1, 2, 3, 11, and 12, but no entry for the other seven transactions because they are not inter-office operations.

(1) To record the transfer of £1,000 to the London branch, at the rate of $4.95:

\[
\begin{align*}
\text{Remittances to London Branch} & \quad \text{\$4,950} \\
\text{Cash} & \quad \text{\$4,950}
\end{align*}
\]

(2) To record the transfer of $2,450 to London branch:

\[
\begin{align*}
\text{Remittances to London Branch} & \quad \text{\$2,450} \\
\text{Cash} & \quad \text{\$2,450}
\end{align*}
\]

(3) To record the merchandise shipped to London branch:

\[
\begin{align*}
\text{London Branch Current} & \quad \text{\$50,500} \\
\text{Shipment to London Branch} & \quad \text{\$50,500}
\end{align*}
\]

(11) To record the transfer from London branch of £4,000 which is sold for $19,800, at $4.95:

\[
\begin{align*}
\text{Cash} & \quad \text{\$19,800} \\
\text{Remittances from London Branch} & \quad \text{\$19,800}
\end{align*}
\]

(12) To record the transfer from London branch of $20,200:

\[
\begin{align*}
\text{Cash} & \quad \text{\$20,200} \\
\text{Remittances from London Branch} & \quad \text{\$20,200}
\end{align*}
\]

The trial balance of the London branch and the conversion from pounds to American dollars are shown on next page, assuming that the exchange rate at the end of the period is $5.10 and closing inventory is £1,000.
**London Branch Trial Balance**

**June 30, 19...**

<table>
<thead>
<tr>
<th></th>
<th>Pounds</th>
<th>Rate</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,500</td>
<td>5.10</td>
<td>7,650</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>3,000</td>
<td>5.10</td>
<td>15,300</td>
</tr>
<tr>
<td>Reserve for Bad Debts</td>
<td>100</td>
<td>5.10</td>
<td>510</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>1,000</td>
<td>4.99</td>
<td>4,990</td>
</tr>
<tr>
<td>Reserve for Depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>1,000</td>
<td>5.10</td>
<td>5,100</td>
</tr>
<tr>
<td>Remittances from Home Office</td>
<td>1,500</td>
<td>R</td>
<td>7,400</td>
</tr>
<tr>
<td>Remittances to Home Office</td>
<td>8,000</td>
<td>R</td>
<td>40,000</td>
</tr>
<tr>
<td>Home Office Current</td>
<td>10,000</td>
<td>R</td>
<td>50,500</td>
</tr>
<tr>
<td>Merchandise from Home Office</td>
<td>10,000</td>
<td>R</td>
<td>50,500</td>
</tr>
<tr>
<td>Sales</td>
<td>16,000</td>
<td>5.00</td>
<td>80,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>2,000</td>
<td>5.00</td>
<td>10,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>3,200</td>
<td>5.00</td>
<td>16,000</td>
</tr>
<tr>
<td></td>
<td>22,700</td>
<td></td>
<td>144,440</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>144,440</td>
</tr>
<tr>
<td>Exchange Adjustment</td>
<td></td>
<td>431</td>
<td></td>
</tr>
<tr>
<td>Closing Inventory</td>
<td>1,000</td>
<td>5.10</td>
<td>5,100</td>
</tr>
</tbody>
</table>

It will be noted that Cash, Accounts Receivable, Reserve for Bad Debts, and Accounts Payable are converted at the current rate; Fixed Assets and Reserve for Depreciation at the rate prevailing at the time of payment; Sales, Purchases, and Expenses at the average rate, $5.00, which is obtained by dividing the balance of Remittances to the Home Office account into the balance of Remittances from the London Branch account; and reciprocal accounts by substitution of dollar balances on the home office books. But after conversion, the trial
balance in dollars is not balanced because all items are not converted at the same rate. An adjusting figure, therefore, must be entered on the smaller side. This is the amount of profit or loss due to exchange fluctuations.

The trial balance of the home office books at the end of the period is shown below:

New Orleans Home Office Trial Balance
June 30, 19....

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,600</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>25,000</td>
</tr>
<tr>
<td>Reserve for Bad Debts</td>
<td>$1,000</td>
</tr>
<tr>
<td>London Branch Current</td>
<td>50,500</td>
</tr>
<tr>
<td>Remittances to London Branch</td>
<td>7,400</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>10,000</td>
</tr>
<tr>
<td>Reserve for Depreciation</td>
<td>1,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>10,000</td>
</tr>
<tr>
<td>Remittances from London Branch</td>
<td>40,000</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>75,000</td>
</tr>
<tr>
<td>Shipments to London Branch</td>
<td>50,500</td>
</tr>
<tr>
<td>Sales</td>
<td>175,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>207,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>32,000</td>
</tr>
<tr>
<td></td>
<td>$352,500</td>
</tr>
<tr>
<td>Closing Inventory</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Before preparing the consolidated statements of the New Orleans home office and its London branch, closing entries for the home office books must be made, as follows:

1) To deduct the purchases which are sent to London branch:

   Shipment to London Branch........... $50,500
   Purchases.......................... $50,500
(2) To transfer purchases and expenses to profit and loss:

Profit and Loss....................... $188,500
Purchases.............................. $156,500
Expenses............................... $32,000

(3) To transfer sales and closing inventory to profit and loss:

Sales................................. $175,000
Closing Inventory...................... $30,000
Profit and Loss....................... $205,000

(4) To close up the inter-office accounts:

London Branch Current............... $7,400
Remittances from London Branch..... $40,000
Remittances to London Branch...... $7,400
London Branch Current.............. $40,000

(5) To record the net operating profit of London branch, as per the branch Profit and Loss Statement in dollars.

London Branch Current............... $8,600
Branch Profit and Loss.............. $8,600

(6) To record the profit made through exchange fluctuations.

London Branch Current............... $431
Branch Profit and Loss.............. $431
To close both home office profit and branch profit into surplus:

Profit and Loss: $16,500
Branch Profit and Loss: $9,031
Surplus: $25,531

The consolidated balance sheet work-sheet is shown below:

The _______ Export Company

Consolidated Balance Sheet Work Sheet

June 30, 19...

<table>
<thead>
<tr>
<th>Home Office</th>
<th>London Branch</th>
<th>Eliminations</th>
<th>Combined B/S</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash........</td>
<td>$20,600</td>
<td>$7,650</td>
<td>$28,250</td>
</tr>
<tr>
<td>*Accounts Receivable..</td>
<td>24,000</td>
<td>14,790</td>
<td>38,790</td>
</tr>
<tr>
<td>Closing Inventory....</td>
<td>30,000</td>
<td>5,100</td>
<td>35,100</td>
</tr>
<tr>
<td>*Fixed Assets.........</td>
<td>9,000</td>
<td>4,491</td>
<td>13,491</td>
</tr>
<tr>
<td>London Branch Current</td>
<td>26,931</td>
<td></td>
<td>$26,931</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$110,531</td>
<td>$32,031</td>
<td>$26,931</td>
<td>$115,631</td>
</tr>
</tbody>
</table>

Liabilities and Net Worth:

| Accounts Payable..... | $10,000 | $5,100 | $15,100 |
| Capital Stock........ | 75,000  | 75,000 |         |
| Surplus............. | 25,531  | 26,931 | 25,531  |
| Home Office Current.. |         | 26,931 | $26,931 |
|                      |         |        |         |
| $110,531            | $32,031 | $26,931 | $115,631 |

* Reserve are deducted for simplicity

There is another method to record the $431 profit on exchange illustrated as entry No. (6). Since the $431 is
earned as the result of exchange fluctuations and unrealized, it is possible that the profit may be offset by losses from exchange fluctuations in the succeeding period. Therefore, it is suggested that a Reserve for Exchange Fluctuation account should be established and listed on the Consolidated Balance Sheet. The entry would be:

\[
\begin{align*}
\text{London Branch Current} & : \quad 431 \\
\text{Reserve for Exchange Fluctuations} & : \quad 431
\end{align*}
\]

This method is more conservative than the first one, and practical as well.

The consolidated profit and loss statement is illustrated on next page, with the following numbers stand for different accounts:

(1) Sales  
(2) Cost of Goods Sold  
(3) Purchases  
(4) Merchandise from Home Office  
(5) Closing Inventory  
(6) Cost of Goods Sold  
(7) Gross Profit  
(8) Expenses  
(9) Net Profit  
(10) Exchange Adjustment  
(11) Profit
The Export Company

Consolidated Profit and Loss Statement Work Sheet

June 30, 19...

<table>
<thead>
<tr>
<th></th>
<th>Home Office</th>
<th>London Branch</th>
<th>Consolidated P. &amp; L.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>$175,000</td>
<td>$80,000</td>
<td>$255,000</td>
</tr>
<tr>
<td>Less (2):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) $207,000</td>
<td>$10,000</td>
<td>$217,000</td>
<td></td>
</tr>
<tr>
<td>(4) 50,500</td>
<td>50,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$156,500</td>
<td>$60,500</td>
<td></td>
</tr>
<tr>
<td>Less (5)</td>
<td>30,000</td>
<td>5,100</td>
<td>$35,100</td>
</tr>
<tr>
<td>(6)</td>
<td>126,500</td>
<td>55,400</td>
<td>181,900</td>
</tr>
<tr>
<td>(7)</td>
<td>$48,500</td>
<td>$24,600</td>
<td>$73,100</td>
</tr>
<tr>
<td>Less (8)</td>
<td>32,000</td>
<td>16,000</td>
<td>48,000</td>
</tr>
<tr>
<td>(9)</td>
<td>$16,500</td>
<td>$8,600</td>
<td>$25,100</td>
</tr>
<tr>
<td>Add (10)</td>
<td></td>
<td>431</td>
<td></td>
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Before the second World War, many American industries had their assembling or manufacturing plants operated profitably in foreign countries. The chief reasons that make this operation profitable can be explained as follows.

It is a well-known fact that transportation costs, even in domestic trade, may often be decreased by shipping the component parts, and then assembling them near the market. In shipping to foreign countries it may also be discovered that the component parts are subject to lower duties than the finished products. Therefore, if a packing plant is established near the foreign market, part of the transportation cost and customs duties will be saved. There are many articles that may receive their final form in the foreign market by combining the home-made product with foreign local manufacturing. Great economy can be achieved without affecting the quality of the products.

Moreover, the transportation costs and import

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1Huebner and Kramer, op. cit., p. 259.
duties can be completely eliminated if a plant is established to manufacture the entire product abroad. There are other savings, such as cheap labor and cheap raw materials in the foreign market, which may be utilized and which will decrease production costs. Furthermore, the fact that the factory is located in the country where the goods are sold may have a very desirable effect upon consumers. The product becomes a national product and can be labeled "Made in England" or "Made in France." These labels, without doubt, will bring a decided advantage in the market to the manufacturers.

But, on the other hand, there are factors which are unfavorable to the establishing of foreign manufacturing plants, and which should be carefully studied before the final decision is made. These factors are: the problem of increased overhead cost, the elasticity of the demand in the foreign market, the governmental regulations on foreign capitals, the study of local cartels and labor unions, and also the accounting problem. An accountant who is designing the accounting system for a foreign manufacturing plant will face the following problems:

(1) the problem of ascertaining the value, in home currency, of the plant which is constructed in the foreign country;

(2) the problem of providing adequate depreciation reserves for the foreign plant; and
(3) the problem of estimating the cost of production in the case of raw materials and supplies which are shipped from home.

The application of inappropriate exchange rates to make conversions from foreign currency into home currency for bookkeeping purposes does not always perpetuate an error, for some errors can be automatically adjusted in the same or in the next fiscal period. However, in the case of fixed assets, such as manufacturing plants, an over-valued or under-valued conversion will create an incorrect figure which remains on the books throughout the life of the assets, except to the extent to which it may gradually be reduced from year to year by the writing-off of depreciation, or to the extent to which it may be removed by the sale of assets. Moreover, an over-valued or under-valued capital account will automatically entail an overstatement or an understatement of profits.

The difficulty of ascertaining the value of a foreign constructed factory, in home currency, arises out of the fluctuation of exchange rates. For instance, an American manufacturing company decides to build a foreign manufacturing branch in London. It purchases a draft of £10,000 at a cost of $50,000 and deposits this draft in a London bank for the purpose of constructing the plant. Assume that the money is remitted in the middle of September when the exchange rate is $5.00, but that at the end of the year the exchange rate drops
to $4.75. Assume further that £5,000 of the original amount is spent for the payment of labor and raw materials for the construction of the plant, and that the remaining £5,000 is still in the London bank account. According to the rules for conversion, the remaining £5,000 should be converted at the current rate, $4.75, or an equivalent of $23,750, thus there is a loss of $1,250 as compared with its original cost of $25,000 when the exchange rate was $5.00. The question now arises as to whether such exchange loss should be debited to the account of the new plant, or whether it should be taken to the profit and loss account.

In view of the fact that the money deposited in the London bank does not form any part of the current assets or working capital necessary for the carrying on of the business, or for its maintenance or operation, but is definitely earmarked for capital purpose, it would seem reasonable that any loss, owing to a decline in the rate of exchange between the time when it is accumulated and the time when it is expended, should be charged to the capital account as being incidental to the capital expenditure program and in no way connected with the revenue account. It will be the same if the American manufacturing company does not carry out the construction program itself, but has made arrangements for a contractor to undertake it at a fixed price. Because the contractor knows he has to provide cash in pounds sterling in advance of the time when he is required to spend them, and thus is faced with
the possible losses which might occur by the reason of variations in the rates of exchange, he would, therefore, increase his contract price. In this case, the American manufacturing company will have to charge the whole contract price to the account of the new plant, although the contract price will certainly include a reserve for possible losses on exchange, and also presumably an amount representing the contractor's profit.

On the other hand, it would be preferable, as a measure of financial prudence, to write off the loss to the profit and loss account, in order that the charges to the capital account may be limited to the actual cost of the construction of the new foreign factory, and will not contain any exchange losses, although such losses may be incidental to the capital expenditure program and not connected with revenue. This argument can also be strengthened by an illustration involving a similar principle. Assume that the American manufacturing company, instead of sending its money to London to build a new factory, issues a long term bond for £10,000 in the London financial market and purchases the same kind of plant with the proceeds. At the time of purchase the exchange rate is $5.00, and therefore, in the balance sheet of the American manufacturing company the transaction appears thus:

Under the title of Fixed Assets:

Manufacturing Plant in England..............$50,000
Under the title of Liabilities:

Bonds Payable..............................$50,000

At the end of the year, however, the exchange rate of sterling rises to $5.15. Consequently the balance sheet will appear as follows:

Under the title of Fixed Assets:

Manufacturing Plant in England...$50,000

Loss on exchange in connection with bonds issued in England for £10,000................. 1,500  $51,500

Under the title of Liabilities:

Bonds Payable.......................$51,500

For the above case, no accountant would suggest declaring that the loss on exchange could be carried to the account of the plant in England.

Therefore, the chief question is whether such exchange profits or losses should be credited or debited to the capital account, or whether they should be taken to the profit and loss account. It is difficult to make decision applicable in all cases, but a tentative conclusion can be drawn as follows:2

(1) For the sake of conservative practice, it is advisable to follow the prudent rule that, if there

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is a loss, it should be written-off to the revenue account, and, if a profit, it should be taken to the credit of the capital account.

(2) If a loss on exchange is charged to the capital account, it should be shown separately in any statement of accounts, not included as part of the actual cost of the fixed assets.

After the new factory is set up in a foreign country, there is another item that should be considered - capital expenditure. Expenditures for plant and equipment and for replacements, not including expenditures for maintenance and for ordinary and necessary repairs, are capital expenditures and should be charged to the capital account recoverable through depreciation. Capital expenditure may be said to be composed of wages, of materials, and of administrative and other charges incurred on capital account. The methods used to convert these expenditures are discussed separately.

The usual practice to ascertain the equivalent, in terms of home currency, of the wages paid in the foreign currency on the capital account is to convert the monthly totals of the wages at the average of the daily rates of exchange prevailing during the month; or, in cases where the foreign currency does not vary greatly in value, to convert the totals of the wages at the average of the daily rates of exchange prevailing during a period of three months, or even
six months. The choice between dealing with the totals at short or at longer intervals depends, in the first place, on the extent of the variations in the value of the currency, and, secondly, on the question as to whether the wages are being incurred more or less evenly over a period, or whether they are much heavier in some months than in others. In case of doubt it is preferable to use shorter periods. For example, an American company owns a railway system in Brazil and carries on a capital expenditure program throughout the year. During the fiscal year in question the average rate of exchange, let it be assumed, has been ten Brazilian milreis for one American dollar. The total capital expenditure on wages during the year is 25,000 Brazilian milreis which is converted at the rate of 10 milreis to one American dollar for a total of $2,500. But on closer examination it is ascertained that 20,000 of the 25,000 Brazilian milreis are expended during the first month of the year, and also that the exchange rate during the first month is 8 milreis for one American dollar. Therefore, the 20,000 Brazilian milreis should be converted at the rate prevailing during the first month. At the rate of 8 milreis for one American dollar, 20,000 Brazilian milreis equal to $2,500, while at the rate of 10 milreis to one they equal only $2,000. The basis of applying to the 20,000 milreis the average rate of exchange during the year would result in the capital account being undercharged by $500. It will be noted, from the above
example, how an accurate conversion of wages can be made.

Raw materials used for capital expenditures can be classified into two kinds: (1) raw materials purchased in foreign currency from the local market where the capital expenditure program is being carried out, or (2) raw materials shipped from the home office. Local purchases of raw materials should be converted at the rate at the time they are purchased, for such a value expresses their cost, it is at their cost price that they are required to be recorded in the capital expenditure account in the books. Raw materials transferred from the home office will give no conversion troubles, since their value is recorded in the home office books.

With respect to items other than wages and raw materials which can enter into the composition of capital expenditure, according to the general principle, they should be converted into the home currency at the rate of exchange prevailing at the time when the expenditure is incurred. But in actual practice this conversion may be achieved by dealing with totals monthly, quarterly, half-yearly or yearly, as may be appropriate, and by converting these totals at the average rate of exchange of the corresponding period.

The problem of providing adequate depreciation reserves for a foreign plant is also connected with the fluctuations of exchange rates. Let it be assumed that a machine is purchased for the London plant at a cost of £2,000,
and that it is estimated that this machine can be operated efficiently for ten years. Obviously the depreciation reserve for each of the ten years will be increased £200, in order to amortize the cost of the asset. Assume that the exchange rate for pound sterling is $5.00 at the time when the payment of the purchase is made. The dollar value of this machine is, therefore, $10,000. If during the 10-year period the average exchange rate for pound sterling is $4.75, then the depreciation reserve account, accumulated during the 10 years, will amount at the end of that time to $9,500, which will be insufficient to amortize the cost of the machine at the end of its economic life.

The depreciation problem will be easy to handle if the fixed assets used by the branch are carried on the home office books; the assets then will be carried in American dollars. Any expenditure made on account of fixed assets by the branch is charged to the home office account in foreign currency. The branch notifies the home office of the expenditure and of the rate effective on the date of the expenditure. The home office debits the branch Fixed Assets account and credits the branch Current account with the dollar value secured by converting at the stated rate. Depreciation reserves are also set up on the home office books. The following entry will be made on the home office books each year after the home office has taken up the profit reported by the branch.
Branch Office Profit and Loss.....$_____

Depreciation Reserve -
Branch Assets...............$_____

If the fixed assets are carried on the books of the foreign branch, the fixed assets account in the branch ledger should be equipped with two columns on either side in order to record the value of the assets in both foreign and home currency. Expenditures on account of fixed assets made by the London branch, therefore, should be charged to the account in pounds sterling, and at the same time a memorandum entry should be made in the dollar column stating the dollar value of the pounds sterling expended. On the other hand, if the fixed assets are purchased by the home office and shipped to the London branch, the home office charges the London Branch Current account with American dollars expended and notifies the branch of the dollar value and pounds sterling equivalent at the date of payment. Accordingly, the branch debits the proper fixed assets account at both dollars and pounds sterling. Where this plan is used, the fixed assets ledger on the branch books will show dollar cost as well as cost expressed in pounds sterling. Thus, great help is given for the handling of depreciation problems, and discrepancies between the balance in pounds sterling can be adjusted to the balance in dollars. Depreciation reserves can be set up by using either of the following methods:

(1) The depreciation reserve, which is expressed on the
London branch books in pounds sterling, is converted into dollars on a percentage basis. Thus if the depreciation reserve balance is 10% of the corresponding asset account balance, the reserve should be 10% of the asset balance when stated in dollars.

(2) The depreciation reserve which is expressed in pounds sterling can be converted into dollars at the same rate as is applied to the fixed asset account.3

If a manufacturing plant is established in a foreign country, the accounting problem, like that of the domestic manufacturing plant, is to compute the manufacturing costs. The problem may be complicated by the fact that the foreign plant may receive cash and raw materials, or even semi-manufactured-products, from the home office. Hence, it will be necessary to convert their dollar costs into foreign currency at different rates at different dates during the period. When they are employed for production, their value in foreign currency, as well as their original dollar cost, should be charged to the accounts of Goods-in-Process or to the account of Finished Goods. This dollar cost may be computed on the first-in first-out theory, or the last-in first-out theory, or by the use of an average rate.

The following illustration shows how the first-in

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first-out theory is applied. Assume that an American manufacturing company establishes a foreign manufacturing plant in London and supplies the London branch with both working funds and semi-manufactured raw materials. The following transactions occur:

1. The London plant receives a draft of £10,000, which was purchased at the rate of $5.00 by the American manufacturing company home office, and which was assigned as working fund.

2. The London plant receives $15,300 worth of semi-manufactured raw materials from home office, when the rate was $5.10.

3. The London plant pays £5,000 for raw materials purchased from the local market.

4. The London plant pays £2,000 for administrative expenses.

5. Raw materials, which are purchased from the local market and costed £4,000, are transferred to Goods-in-Process.


7. The London plant pays £2,000 for direct labor.

8. One-half of the Goods-in-Process are completed and transferred to Finished Goods account.

9. The London plant receives another draft from home office for £10,000, which is purchased at the rate of $5.10.
(10) Another shipment of semi-manufactured raw materials is received from the home office, cost $14,100, when the rate is $4.90.

(11) The London plant pays £4,000 for raw materials purchased at the local market. Dollar value for the first £1,000 is $5.00; for the other £3,000, $5.10.

(12) The second-half of the Goods-in-Process is completed and transferred to the Finished Goods account.

(13) Raw materials of £4,000 purchased from the local market are transferred to Goods-in-Process.

(14) Semi-manufactured raw materials of £2,000 are transferred to Goods-in-Process. Dollar value for the first £1,000 is $5.10; for the second £1,000, $4.90.

(15) The London plant pays £2,000 for direct labor.

(16) The London plant pays £2,000 for administrative expenses.

(17) One-half of the Goods-in-Process is completed and transferred to the Finished Goods account.

The ledger accounts for the above transactions on the London plant's book are shown on the following pages.
### Cash

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### Raw Materials - Local Purchases

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### Semi-Manufactured Raw Materials

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### Goods-in-Process

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### Remittances from Home Office

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### Home Office Current

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The London branch plant's trial balance is shown on the next page.
# London Branch Trial Balance

**Date:**********

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<td>Raw Materials</td>
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<td>Semi-Mfd. Raw Materials</td>
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<td>Goods-in-Process</td>
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<td>Finished Goods</td>
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**L26,000** **L26,000**
CHAPTER VI

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN SUBSIDIARIES

A foreign subsidiary is a corporation located in a foreign country but of whose voting stock the majority is owned by another corporation in the home country. The purposes of having a subsidiary in foreign countries can be summarized generally as follows:¹

(1) The laws of different countries frequently discriminate between domestic and foreign corporations. There are certain types of business which may be conducted only by domestic corporations. Aside from direct prohibitions of this nature, foreign corporations usually are subjected to heavier taxation and to the necessity of making burdensome reports. Therefore, the formation of a subsidiary in a foreign country is an obvious means of solution.

(2) Gaining control of subsidiaries employing a smaller amount of capital is another aim. Control of a

corporation can be held legally by an agency when it possesses sufficient voting strength to elect a majority of the board of directors. If the stockholders of the subsidiary are unorganized and widely scattered, the direct control of the subsidiary will be obtained even more easily by owning a smaller amount of voting stock. Greater economy is thus achieved.

(3) An old and well-established firm which has a product of high quality that has gradually acquired a reputation for high standards is unwilling to place its name on a cheaper product of lower quality. But at the same time the firm wants to extend its sales to foreign markets where the standard of living is lower. A subsidiary concern is formed to produce and market the lower-priced product to meet the foreign demands.

(4) Another purpose for having a foreign subsidiary is to eliminate foreign competition. Advertising expenses, overhead in general, inventories, duplicated equipment, etc. are saved. Moreover, instead of competing, the foreign subsidiary may cooperate and specialize in particular types and varieties of products.

(5) It usually happens that a company desires to produce
a certain article by using foreign raw materials, which have not been tried out. If a subsidiary is employed for this task, in case of failure it will not seriously affect the home company and its product.

(6) Foreign subsidiaries often are employed to conceal the identity of the home corporation for the purpose of fighting competitors in the foreign market, or for the purpose of selling out-of-date or obsolete commodities.

(7) Foreign subsidiaries may be formed also for purely investment purposes.

As compared with foreign branch accounting, the accounting problem for foreign subsidiaries is different because foreign subsidiaries are organized as separate companies and incorporated under the laws of a foreign country. Their accounting systems, therefore, are completely independent of their parent companies. On the other hand, the parent company should carry an Investment in the Foreign Subsidiary account in which to record the cost of investments in terms of its own home currency. Furthermore, not every subsidiary is necessarily 100 per cent owned by a parent company in another country. For the purpose of control, the ownership of a subsidiary can be varied in a range of from 45 per cent (sometimes even less) to 100 per cent. Thus, an
accounting problem has arisen as to what percentage of ownership is required for the consolidation of the subsidiary's balance sheet with its parent company's balance sheet.\(^2\)

This problem is one of the most difficult accounting problems for which there is as yet no uniform and satisfactory solution. Modern accountants, particularly Walter A. Staub and W. A. Paton, summarize their opinions as follows:

Walter A. Staub says:

"It seems clear that no arithmetical rule can be laid down requiring, for example, that all companies over a certain percentage of stock ownership shall be consolidated, and all others below the named percentage not consolidated. The circumstances of each case must be considered, and there are too many factors involved to permit a simple rule of this kind.

"Among the factors which naturally call for consideration are percentage of stock ownership, class or classes of stock owned, voting control or absence thereof, management control, and economic or other relations to parent or other companies in the affiliated group.....The factors of management control and intercompany economic relations, where there is less than 50 per cent stock ownership, might not ordinarily be thought of as sufficient to warrant consolidation. Yet, they should receive consideration because the intercompany relations may be such that the company owning a minority of the stock and having the management control may, for the sake of its own business, have to finance operating losses of such an affiliated company.

\(^2\)As to when the consolidation can be made is another problem. The Security and Exchange Commission has laid down the following rule, Regulation S-X, Rule 4.02; "If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if the following conditions exist: (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of different closing dates is briefly explained;...."
"As a general rule, if a consolidated balance sheet is prepared at all, every wholly-owned company should be included. The United States Treasury has consistently held to this principle with respect to consolidated income-tax returns and has insisted ever since 1922 that the option must be exercised 'all or none.' In other words, partial consolidation is not permitted....In the case of financial statements submitted to stockholders or used for credit purposes, an argument is sometimes made for excluding a wholly-owned subsidiary from the consolidated statement, where the nature of its business is such that it is informing to show it separately."3


"The exact percentage of stock ownership which should obtain before the statements of the controlled company are to be included in consolidation cannot be stated. The only points on which there seems to be agreement are: (1) all wholly-owned subsidiaries should be included (assuming that dissimilarity of operations does not make this inadvisable); (2) all companies in which ownership below 50 per cent should, ordinarily, be excluded. Between these two limits each case must be decided on its merits.

"The Securities and Exchange Commission (Regulation S-X) has adopted the rule that 'the registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary.'

"Under the Revenue Act of 1942 affiliated corporations are again permitted to file consolidated tax returns under prescribed conditions. For this purpose an 'affiliated group' is defined as one or more 'chains' of corporations connected with a common parent corporation provided at least 95 per cent of the 'voting power of all classes of stock' and 95 per cent 'of each class of the nonvoting stock' of each corporation (except the parent) is owned directly by one or more of the other corporations in the group and the parent corporation owns directly at least 95 per cent of the stock of at least one of the companies."4


The above answers are far from uniform and cannot be satisfactorily applied to all the various conditions of business ownership. In like manner, actual practice varies much between companies. In 1943, an investigation concerning 47 top-ranking American corporations was made by an accounting class at Louisiana State University under the direction of Professor E. A. Saliers. The following facts were discovered.

Table III

The Requirements of the Percentages of Ownership for Consolidation, from the Study of 47 American Corporations in February 1943

<table>
<thead>
<tr>
<th>Ownership Percentage</th>
<th>Consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% or above, owned and consolidated</td>
<td>16%</td>
</tr>
<tr>
<td>75% or above, owned and consolidated</td>
<td>2%</td>
</tr>
<tr>
<td>80% or above, owned and consolidated</td>
<td>2%</td>
</tr>
<tr>
<td>Only 100% owned consolidated</td>
<td>74%</td>
</tr>
<tr>
<td>No consolidated statement</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

This investigation reveals not only the differences of actual practices among the corporations but also the devi-

5J. Bennett, "Bases of Consolidation," p. 4, (Unpublished)
ation from the theory of actual practice. It can be noted from the table that the general practice of the majority is to consolidate only wholly-owned subsidiaries. Therefore, it seems that it is impossible to have a uniform solution for this problem. However, one thing can be added here. No matter whether or not the subsidiary's statements are consolidated with the parent company's, a detailed report of the financial condition of the subsidiary company should accompany the statements of the parent company in order to provide information and also protection to investors and stockholders.

Despite varying opinions regarding the requirements of certain percentages of ownership for consolidation, the methods of handling accounts for Investments in Foreign Subsidiaries are all based on the same accounting principle. Accounts covering investments in foreign subsidiaries may conveniently be classified under control accounts covering:

(1) Investments in foreign subsidiaries which are carried as investments in the consolidated balance sheet;

(2) Investments in foreign subsidiaries which are eliminated since their balance sheet are included in the consolidated balance sheet.

Under these classifications, separate accounts are kept for the investments in each of the foreign subsidiaries. The most common practice is to set up the investment in an
account under the proper controlling account at cost, in home currency; and in the subsidiary ledger the value of the investments is kept in both foreign currency and its equivalent in home currency at the rate at the time of acquisition. If there is a profit earned by the foreign subsidiary and still kept in the books of the subsidiary, the Investments account should be charged for its equivalent in home currency at the current rate of exchange. When dividends are received from the foreign subsidiary in foreign currency, they should be converted at the current rate of exchange into home currency and credited to the Investments account. It will have the same treatment if a loss is incurred by the foreign subsidiary. Where this method is used, it is necessary to make an analysis of these Investment accounts when the consolidated balance sheet is prepared. To illustrate the procedure, the following situation is assumed: Investment in the stock of a London company is $200,000, which is the equivalent of £40,000 at the rate of $5.00, being 100% ownership. Of the £40,000, £30,000 represents the par value of capital stock, and £10,000 represents the surplus. Assume also profits for the first year of £2,000 and dividends paid of £1,000. The entries would be as follows:

(1) To record the investment in the stock of a London company for £40,000, the exchange rate at the time when the purchase is made being $5.00.

Investment in London Company...... $200,000

Cash............................... $200,000
(2) To record the earnings of £2,000 for the period at the average rate for the period, $5.05.

Investment in London Company....... $10,100
Profit and Loss...................... $10,100

(3) To record the dividends received, assuming that the exchange rate at the time when the dividends are received is $5.03.

Cash................................. $5,030
Exchange Adjustment................. 20

Investment in London Company.... $5,050

Upon the preparation of the consolidated balance sheet the adjustments to be made on these accounts would be:

<table>
<thead>
<tr>
<th>Parent Company</th>
<th>London Company</th>
<th>Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in London Company........</td>
<td>$205,050</td>
<td>$205,050 Cr.</td>
</tr>
<tr>
<td>Capital Stock.................</td>
<td>$150,000</td>
<td>150,000 Dr.</td>
</tr>
<tr>
<td>Surplus.........................</td>
<td>55,050</td>
<td>55,050 Dr.</td>
</tr>
<tr>
<td>Total.........................</td>
<td>$205,050</td>
<td>$205,050</td>
</tr>
</tbody>
</table>

There is another method of handling the Investment account - analyzing the foreign investment at the time such investment is made and setting up on the books of the parent company the investment in the foreign subsidiary in the following accounts:
(1) Investment in capital stock of the foreign subsidiary company at par.

(2) Surplus of the subsidiary company.

This plan has distinct advantages in that it makes the preparation of consolidated balance sheets thereafter a relatively simple procedure. The entries are:

(1) To record the investment in the stock of a London company for £40,000, at the rate of $5.00.

Investment in London Company...$200,000

Cash............................... $200,000

(2) To break up the investment in the London subsidiary company into its elements.

Investment in Capital Stock of the London Company.............. $150,000

Surplus of the London Subsidiary Company.......................... $50,000

Investment in London Company... $200,000

(3) To take up the earnings of the London subsidiary company for the period, £2,000, at $5.05.

Surplus of the London Subsidiary Company...................... $10,100

Profit and Loss................................. $10,100

(4) To record the dividends received from the London company, £1,000 and their conversion at $5.03.

Cash............................... $5,030

Exchange Adjustment............. $20

Surplus of the London Subsidiary Company...................... $5,050
The capital stock and surplus accounts on the books of the parent company where this method is used should always represent the equivalents, at corresponding exchange rates, shown for capital stock and surplus on the books of the London company. In the preparation of the consolidated balance sheet, these Investment and Capital accounts would appear as follows:

<table>
<thead>
<tr>
<th></th>
<th>Parent Company</th>
<th>London Company</th>
<th>Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>On Parent Company Books:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Capital Stock of London Co...</td>
<td>$150,000</td>
<td></td>
<td>$150,000Cr.</td>
</tr>
<tr>
<td>Surplus of the London Company...</td>
<td>55,050</td>
<td></td>
<td>55,050Cr.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Parent Company</th>
<th>London Company</th>
<th>Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>On London Company Books:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stock...</td>
<td>$150,000</td>
<td></td>
<td>150,000Dr.</td>
</tr>
<tr>
<td>Surplus...</td>
<td>55,050</td>
<td></td>
<td>55,050Dr.</td>
</tr>
</tbody>
</table>

$205,050 $205,050

If a subsidiary company is included in the consolidation, the Investment accounts of the parent company are eliminated; but if the subsidiary company is not included in the consolidation, the Investment accounts will appear in the consolidated balance sheet. Thus, there is the question of the valuation at which the investment should appear in the balance sheet. The valuation of this account depends, of course, on the financial position of the foreign subsidiary company shown by its balance sheet and the condition of its business. Presumably this investment is to be carried at purchase cost plus accumulated earnings and less losses and
dividends, as explained on the preceding page. The verifica-
tion of this account necessarily involves consideration
of the balance sheet of the foreign subsidiary. There is
to be considered not only the possible shrinkage in value of
such foreign investments in their foreign currency, but also
the additional shrinkage occurring on conversion of such
foreign money values to domestic currency values. That is,
the valuation of such foreign investments for balance sheet
purposes should be what those investments would realize to
the parent company in its own home currency if the invest-
ments were marketed. If there is an established domestic
market for such, the market quotation will be used as a
basis. If no domestic market is available, the foreign
market must be considered and the amount realizable in foreign
moneys must be converted into home currency to arrive at what
they are worth to the parent company on the basis of their
present market value.

In case of consolidation, the conversion will be
made in much the same manner as is followed in the consoli-
dation of the statements of a parent company and its foreign
branches. The subsidiary Capital Stock account should be
substituted for the dollar price paid by the parent company,
and the subsidiary Surplus account should be arbitrarily
stated at an amount which will bring the subsidiary balance
sheet into balance after conversion into home currency. If
the parent company's Investment account does not agree with
the subsidiary's capital stock plus surplus (or minus deficit) as thus converted, an adjusting entry should be made debiting or crediting the Investment account, with an offsetting debit or credit to the Surplus account. But the accounting procedure will be complicated if there is a minority interest in the foreign subsidiary accounts; it should then be stated as a separate item in the consolidated balance sheet. From the point of view of the organization or the outside world, this minority stockholders' interest is a part of the net worth, but from the viewpoint of the parent company this interest can not be considered as a part of the net worth. To illustrate this procedure, let it be assumed that an American trading company owns 90% of the capital stock of its London subsidiary company. The following is the balance sheet of the London company and the conversions:

**London Co. Balance Sheet & Conversion**

<table>
<thead>
<tr>
<th>Date</th>
<th>Pounds</th>
<th>Rate</th>
<th>U.S.$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>5,000</td>
<td>5.05</td>
<td>25,250</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>25,000</td>
<td>5.05</td>
<td>126,250</td>
</tr>
<tr>
<td>Inventories</td>
<td>30,000</td>
<td>5.05</td>
<td>161,500</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>40,000</td>
<td>5.00</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>100,000</td>
<td></td>
<td>502,000</td>
</tr>
<tr>
<td><strong>Liabilities &amp; Capital:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>20,000</td>
<td>5.05</td>
<td>101,000</td>
</tr>
<tr>
<td>Parent Company Current</td>
<td>20,000</td>
<td>S</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>50,000</td>
<td>5.00</td>
<td>250,000</td>
</tr>
<tr>
<td>Surplus</td>
<td>10,000</td>
<td>5.05</td>
<td>50,500</td>
</tr>
<tr>
<td><strong>Total Liabilities &amp; Capital</strong></td>
<td>100,000</td>
<td></td>
<td>501,500</td>
</tr>
<tr>
<td>Exchange Adjustment</td>
<td></td>
<td></td>
<td>500</td>
</tr>
</tbody>
</table>

*Rate: Current rate - $5.05; S - Substitution; Fixed Assets and Capital Stock - at the rate at the time of acquisition.
American Trading Company and London Subsidiary
Consolidated Balance Sheet Work Sheet
Date:.............

<table>
<thead>
<tr>
<th>Parent Company</th>
<th>London Company</th>
<th>Adjustments</th>
<th>Eliminations</th>
<th>Consolidated B.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
<td>25,250</td>
<td></td>
<td>125,250</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>300,000</td>
<td>125,250</td>
<td></td>
<td>426,250</td>
</tr>
<tr>
<td>Inventories</td>
<td>500,000</td>
<td>151,600</td>
<td></td>
<td>651,600</td>
</tr>
<tr>
<td>Investment in London Subsidiary</td>
<td>270,450</td>
<td></td>
<td>450(Dr.)</td>
<td>(2) 270,900(Cr.)</td>
</tr>
<tr>
<td>London Subsidiary Current</td>
<td>100,000</td>
<td>(1) 100,000(Cr.)</td>
<td>100,000(Dr.)</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>500,000</td>
<td>200,000</td>
<td></td>
<td>700,000</td>
</tr>
<tr>
<td></td>
<td>1,770,450</td>
<td>502,000</td>
<td>450</td>
<td>370,900</td>
</tr>
</tbody>
</table>

Liabilities and Net Worth:

| Accounts Payable | 400,000       | 101,000     |              | 501,000          |
| Parent Company Current | 100,000      | (1) 100,000(Dr.) |              |
| Capital Stocks:  |               |             |              |                  |
| Parent Company   | 1,200,000     |             |              | 1,200,000        |
| London Subsidiary | 250,000      |             | (2) 225,000(Dr.) | 25,000          |
| Eliminate 90 per cent |            |             |              |                  |
| Minority 10 per cent |            |             |              |                  |
| Surplus:        | 170,450       | 450(Cr.)    |              | 170,900          |
| Parent Company   | 170,450       | 51,000      |              | 221,450          |
| London Subsidiary |              | (2) 45,900(Dr.) |              |
| Eliminate 90 per cent |            |              |              |                  |
| Minority 10 per cent |            |              |              |                  |
|                       | 1,770,450     | 502,000     | 450          | 370,900          | 1,902,000        |
After the conversion of the balance sheet of the London subsidiary, from pounds sterling to American dollars, $500 profit on exchange results. Since the parent company owns only 90% of the capital stock of the London subsidiary, an adjusting entry of $450 (90% of $500) is made on the books of the parent company as follows:

Investment in London Subsidiary.... $450
Surplus.......................... $450

This entry is shown on the consolidated balance sheet work sheet in the adjustments column on page 103. Besides the adjusting entry for profit on exchange, there are also two entries to eliminate inter-company accounts. One is to eliminate the Inter-company Current accounts, and the other is to eliminate the Investment account on the books of the parent company and 90% of the Capital account and Surplus account on the books of the London subsidiary. The consolidated balance sheet is:

American Trading Co., and London Subsidiary
Consolidated Balance Sheet

<table>
<thead>
<tr>
<th>Date..........</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
</tr>
<tr>
<td>Cash..........</td>
<td>$125,250</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>426,250</td>
</tr>
<tr>
<td>Inventories</td>
<td>651,500</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>700,000</td>
</tr>
<tr>
<td></td>
<td>$1,902,000</td>
</tr>
<tr>
<td>Liabilities &amp;</td>
<td></td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$501,000</td>
</tr>
<tr>
<td>Minority Interests</td>
<td>30,100</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Surplus</td>
<td>170,200</td>
</tr>
<tr>
<td></td>
<td>$1,902,000</td>
</tr>
</tbody>
</table>
The American practice of consolidating foreign subsidiaries was very common during the time before World War II. But since the start of the Sino-Japanese War in 1937 and the European War in 1939, although the United States was still neutral, the treatment of foreign subsidiaries underwent a great change owing to the uncertainty of the international situation. Certain techniques of foreign exchange accounting especially applicable under the present emergency attention and study. The most common practice was to shift toward the conservative policy of consolidating only those subsidiaries which were not in danger of destruction. A study of 48 American corporations having foreign subsidiaries, by an accounting class in the Louisiana State University under the direction of Professor E. A. Saliers, reveals the following statistics:

Table IV

<table>
<thead>
<tr>
<th>Consolidation of:</th>
<th>No. of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>No subsidiary consolidated</td>
<td>11</td>
</tr>
<tr>
<td>Canadian subsidiaries only</td>
<td>6</td>
</tr>
<tr>
<td>Canadian, English, and Australian</td>
<td>7</td>
</tr>
<tr>
<td>Central and South American and Canadian subsidiaries</td>
<td>16</td>
</tr>
<tr>
<td>All subsidiaries in Allied nations</td>
<td>4</td>
</tr>
<tr>
<td>All subsidiaries</td>
<td>4</td>
</tr>
</tbody>
</table>


7P.A.Firmin, "Foreign Subsidiaries." (Unpublished)
Instead of the consolidation of their foreign subsidiaries, conservative American corporations began to list certain of their foreign subsidiaries as Foreign Investments on their balance sheets. In addition to this treatment, the following actions were taken to cope with different situations:  

1. writing-off all of their subsidiaries located in enemy nations and in enemy-occupied territories by application of surplus and appropriate reserves;  
2. setting up a reserve for investments equal to the amount of unrealized profits from all foreign subsidiaries;  
3. reducing their foreign subsidiaries in enemy nations and enemy-occupied territories to the nominal sum of one dollar;  
4. carrying the subsidiaries at cost but offsetting that value completely setting up an equal amount of reserves; and  
5. providing an additional reserve for foreign losses and exchange fluctuations.

During a time of emergency, it is necessary to take the above precautions to protect investors and stockholders. Since foreign exchange accounting deals with international business, and so long as international conflicts can not be avoided, these precautions will be worth studying by the corporations which have foreign investments.

For further study cf. Chapter XI of this paper.
CHAPTER VII

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN EXCHANGE BANKS

As mentioned in Chapter I, there are three kinds of business groups which are interested in foreign exchange accounting. Foreign traders who need foreign exchange to pay for their purchases from abroad or who receive foreign exchange from their sales abroad make up the first group. Foreign investors or business concerns which operate foreign agencies, foreign branches, foreign plants, or foreign subsidiaries make up the second group. They are engaged in activities involving the receipt or remittance of foreign exchange. It will be seen, therefore, that both the first group and the second group are interested in foreign exchange because their business operations are international in character and the value of their assets, liabilities and net worth, and profits and losses, are usually expressed in two or more kinds of currencies. Their businesses and transactions are conducted through a long sequence of conversions from home currency to foreign currency and from foreign currency to home currency. They have to buy foreign exchange whenever they want to pay debts which are stated in the currency of another country. They have to sell foreign ex-
change whenever they receive payment in foreign currency and want to convert into home currency. Therefore, a foreign market is needed to bring together the supply of and demand for foreign exchange.\(^1\) The third group, the foreign exchange banks, thus appear to fill the gap. Their chief business is to deal in foreign exchange, and to treat foreign exchange as a commodity. They make profits by buying foreign exchange at the lowest possible price and selling it at the highest possible price.

As the domestic banks serve the domestic merchants, so the foreign exchange banks offer services to international business men. These services include commercial credits, advances discounts, bank drafts, telegraphic transfers, and so on. However, there are some important differences between the domestic banks and the foreign exchange banks.\(^2\)

(1) Foreign exchange banks generally deal with transactions involving two kinds of currency. For instance, a customer of a bank in New York City wishes to make a remittance to some one in Shanghai. He buys a draft on Shanghai in Chinese dollars but pays the selling bank in American dollars. Another customer clips coupons from an issue of sterling


bonds. The coupons are payable in pounds sterling, but the American customer wants dollars. He sends the coupons to the bank for collection, and he receives dollars when the coupons are collected. Hence, it is necessary for a foreign exchange bank to keep accounts both in dollars and in foreign currencies.

(2) Practically all the foreign exchange transactions of a bank are conducted with the aid of one or more correspondents or branches in foreign countries. No foreign exchange bank can stand alone in foreign transactions, as a domestic bank is frequently does in domestic transactions.

(3) Secured loans in foreign exchange transactions are usually made on commodities and merchandise in transit. They are made on bills of exchange and secured by shipping documents, such as bills of lading, insurance policies, commercial invoices, consular's invoices, packing lists, etc. These bills of exchange are drawn by exporters in the home country on the importers in foreign countries. The function of the foreign exchange banks is to pay the exporter in advance and to collect from the foreign importer later. On the other hand, the most common domestic secured loans are made on marketable securities collateral.
(4) Foreign exchange banks have more transactions involving overdrafts between banks, rediscounting, bankers' time drafts, cable transfers, bankers' acceptances, travelers' letters of credit, and commercial credits, than domestic banks do.

(5) Foreign exchange banks may be used as correspondents for small and medium-sized banks of their own countries. Because there are occasionally some foreign exchange transactions coming to these small banks in the interior of the country, it does not pay to set up a foreign exchange department to deal with such highly specialized business. They can employ the foreign exchange banks located in the seaport and financial centers as their correspondents for foreign exchange transactions.

(6) Besides these commercial foreign exchange transactions, such as the buying and selling of foreign exchange to their customers in connection with international business, the foreign exchange banks usually participate, also, in the world exchange market, buying and selling foreign exchange in the open market as it is offered or demanded for the purposes of speculation, arbitrage, or even investment. These are foreign exchange trading transactions, which have no counterpart in domestic banking.
The foreign exchange business is carried on by two classes of institutions, namely, (1) foreign exchange bankers or dealers whose principal business is dealing with foreign exchange, and (2) banks with a foreign exchange department especially established to carry on this exchange business. The two types may differ as to the treatment of the capital account on the foreign exchange books, but there is no fundamental difference in the accounting methods used. As for the Capital account, in the case of the banker engaged exclusively in foreign exchange, the account represents the usual capital investment found in any business enterprise. But, in the case of the foreign exchange department of a bank, the account represents merely an investment of the bank in this department, or, in other words, a loan by the bank to this department, and is shown as an asset on the general books of the bank.

Investment in Foreign Exchange Department

| Due from Foreign Exchange Department | $100,000 |

And on the books of the foreign exchange department, it will show as follows:

Foreign Exchange Department Capital

| Due to Bank | $100,000 |

When the bank and its foreign exchange department prepare a consolidated statement of their financial condition, these accounts will be eliminated, since they are inter-office accounts and will merge in the total of the bank's assets, liabilities, and capital.

The records and accounts for a foreign exchange banker or the foreign exchange department of a bank can be generally discussed under the following topics:

1. Records of foreign exchange owned and deposited in foreign banks and bankers (Nostro)
2. Records of the amounts of home currency deposited by foreign banks and bankers (Loro)
3. Commercial transactions
4. Trading transactions

In the ledger, the following accounts are usually shown:

1. Assets:
   - Cash
   - Foreign Currencies on Hand
   - Due from Foreign Banks and Bankers
   - Gold Shipments
   - Advance to Customers
   - Accounts Receivable - Foreign Exchange Sales
   - Bills Discounted - Foreign
   - Acceptances Purchased - Foreign

---

4Conto Nostro (our account), Conto Vostro (your account), and Conto Loro (their account), are Italian terms. Because double-entry bookkeeping system originated in Italy, many European business firms and the majority of American banking concerns still adhere to some of the Italian terminology. Cf. A. L. Garles, "Foreign Exchange Arbitrage...." The Journal of Accountancy, Vol. 31, May, 1921, pp. 329-335.

Foreign Investments:
  Short-term Investments
  Long-term Investments

Customers' Liabilities:
  On Acceptances under Letters of Credit
  Under Commercial Letters of Credit
  Under Travelers' Letters of Credit
  Exchange Future Purchased

(2) Liabilities:

Due to Foreign Banks and Bankers
Remittances
Accounts Payable - Foreign Exchange Purchases
Deposits:
  Against Future Contracts
  Funds Retained - Foreign Bills
  Against Travelers' Letters of Credit
Travelers' Checks Outstanding
Commercial Letters of Credit Issued
Travelers' Letters of Credit Issued
Acceptances
Acceptances by Foreign Correspondent
Exchange Future Sold
Capital Account

(3) Income and Expenses:

Interest Earned
Interest Paid
Interest - Foreign Bills Discounted
Cable Expenses
Brokerage
Commissions:
  Travelers' Letters of Credit
  Commercial Letters of Credit
  Remittances
  Acceptances
  Collection Charges
Earnings on Foreign Investments
Expenses - Gold Shipments

Due from Banks and Bankers (Nostro)  Nostro

accounts simply mean the balances which the domestic bank keeps with banks or bankers in foreign countries, against which they draw as the need arises. There is no real difference between the New York bank keeping a deposit account
in a Chicago bank and the same bank keeping a deposit account in a London bank, except that it must keep track of the transactions with foreign banks in both American and foreign currencies, owing to the changing foreign exchange rate. Just as the New York bank charges its Chicago bank account with all deposits, and credits it with all withdrawals, the New York bank charges the Nostro account with all remittances and credits it with all drawings. Both the London bank and the Chicago bank are "correspondents" of the New York bank. But the subsidiary ledger form for the London correspondent, or the Nostro account, is more complicated than that of a domestic correspondent, or the Chicago bank. The Nostro accounts must be kept both in pounds sterling and American dollars. The transactions must be recorded in pounds sterling, or other foreign currencies, in order to keep track of the fluctuations in the balances kept abroad and in order to control the accuracy of charges and credits by the correspondent to the account. The dollar values must be maintained for trial balance and balance sheet purposes and for figuring the profits or losses from exchange transactions. Therefore, the Nostro account, which is shown on the next page, is very complicated, including the following columns:

(1) Date of transaction

(2) Description - To record the name of the customer for whom the transaction was executed or the name of the party abroad to whom payment is to be made, etc.
Illustration VI

Nostro Account

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Numbers</th>
<th>Date of Confirmation</th>
<th>Date</th>
<th>Charges</th>
<th>Detail</th>
<th>Foreign Amount Reconcile-</th>
<th>Foreign Amount</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


(3) **Numbers** - Office record of the number of the transaction.

(4) **Date of Confirmation** - For the date when the transaction was confirmed by letter, or advice, from the foreign correspondents.

(5) **Value Date** - Value date from which interest on the new balance must be figured, this is the date of payment of the draft or cable transfer or the date of receipt of the remittance.

(6) **Charges** - Usually there are cable charges paid by the correspondent, or other special charges and commissions which will be taken from the letter, or advice, sent by the foreign correspondents.

(7) **Foreign Amount in Detail** - Frequently, a large amount, may be drawn, but payable to several different parties. For instance, an American importer may buy a cable of £50,000 to be paid to five different London exporters, £10,000 for each. The several £10,000 amounts would go in this column, and the total amount in the column "Foreign Amount in Total."

(8) **Reconciliation Check** - At stated periods, either monthly or semi-monthly, foreign correspondents send to the New York bank statements of the deposit account showing transactions and balances. The bookkeeping department of the New York bank must
reconcile the statement received from the correspondent with the ledger account in the Nostro ledger, so that check marks can be placed in this column.

(9) Foreign Amount in Total
(10) Rate of Exchange
(11) United States Currency

The transactions entered in the Nostro account can be classified as follows:

(1) Debit entries:
   (a) Remittances by cable, or draft
   (b) Payments or transfers for the depositor's own account
   (c) Purchases of foreign exchange for its own account
   (d) Collections by the correspondent
   (e) Interest and other charges earned

(2) Credit entries:
   (a) Drawings by cable, draft, or letter
   (b) Payments made by correspondent for the depositor's account
   (c) Sales of foreign exchange by the correspondent for the depositor's account
   (e) Interest and charges due to the correspondent

Another peculiarity about the Nostro account is that after the individual debit or credit entries have been made in both foreign and home currencies, there is a very
long wait for the confirmation of the transaction from the foreign correspondent. The length of time depends on the mail service between the countries. A letter, or an advice, will be received from the foreign correspondent to confirm that the cable or draft was received and entry passed accordingly. This letter, or advice, should be checked in detail against the copy of the letter of advice originally sent to the correspondent at the time of the transaction, and also should be checked with the ledger entry, and the final value date should be entered. Then, the letter, or advice, should be filed systematically for future reference after it is marked "correct."

Semi-monthly or monthly, a statement is received from the correspondent, giving all the items debited or credited to the New York bank's deposit account and its daily balances, all in foreign currency units. It should be noted that the credit balance shown on the statement will differ from the debit balance which the New York bank's Nostro account shows. Since there will be drawings and remittances made and recorded on the New York bank's books, which arrived abroad too late to paid or entered on the books of the correspondent at the date of the statement, it becomes necessary to reconcile the foreign correspondent's statement with the New York bank's Nostro account by using a reconciliation form such as is shown on the next page. There are four different types of adjustment, which are listed on
### Illustration VII

#### Reconciliation Statement

<table>
<thead>
<tr>
<th>Account with.........</th>
<th>Date.............</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Explanation</th>
<th>Amount</th>
<th>Date</th>
<th>Explanation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>We debit but not in their account:</td>
<td></td>
<td></td>
<td>We credit but not in their account:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>They debit but not in our account:</td>
<td></td>
<td></td>
<td>They credit but not in our account:</td>
<td></td>
</tr>
</tbody>
</table>
the reconciliation statement, and which are necessary to effect a reconciliation.

(1) We debit but not in their account
(2) We credit but not in their account
(3) They debit but not in our account
(4) They credit but not in our account

Every item on the statement must be checked with the Nostro account and given a check mark if it is correctly recorded on both books; otherwise, it should be listed on the reconciliation statement under one of the above four adjusting groups. These outstanding, or open, items should be verified by an examination of later entries and confirmed by correspondence or otherwise. After all items are checked and outstanding items are listed properly under the four groups, the balance of the Nostro account can be used as a base plus the total of groups (1) and (4), and minus the total of groups (2) and (3); the result thus obtained should be equivalent to the balance shown on the statement from the correspondent.

Due to Banks and Bankers (Loro or Vostro) On the contrary, as compared with Nostro account, Loro accounts are deposits of foreign banks or bankers in this country. They are kept in American currency, or home currency of the bank which receives the deposits. The bookkeeping for Loro accounts is simpler than for the Nostro accounts, as no foreign currency record need be kept of the transactions.
The foreign banks or bankers make dollar remittances or draw dollar drafts on their dollar balances, and foreign currency does not enter into the matter as far as the American bank is concerned. They are practically the same as the domestic Due to Banks account. In turn, a statement of account with a reconciliation form should be sent to all of the banks or bankers concerned, either monthly or semi-monthly.
CHAPTER VIII

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN
EXCHANGE BANKS - COMMERCIAL TRANSACTIONS

If it can be kept in mind that the sales and purchases of foreign exchange are just the same as the sales and purchases of a special commodity, much of the apparent mystery of foreign exchange transactions will disappear. Foreign exchange sales and purchases are operated by the foreign exchange banks through the following channels:

(1) Exchange Sales:

(a) Foreign Currencies
(b) Cable Transfers
(c) Mail Transfers
(d) Demand Drafts
(e) Travelers' Letters of Credit
(f) Commercial Letters of Credit
(g) Forward Sales

(2) Exchange Purchases:

(a) Foreign Currencies
(b) Collections
(c) Discounts
(d) Advances
(e) Purchases of Foreign Bills
(f) Commercial Letters of Credit

(g) Forward Purchases

Exchange Sales

**Foreign Currencies** - For the convenience of travelers who are planning to leave for foreign countries, the foreign exchange banks generally keep on hand for sale foreign specie or paper money of other countries. An account is usually kept with the currency of each country, either in the general ledger or in a subsidiary ledger, showing the balance on hand for each kind of foreign money in terms of the foreign currency and also its cost in home currency. The accounts are charged with the cost of the foreign currency in home currency and with the amount purchased, and are credited with the sales in home currency and with the amount sold. The difference between the debits and credits of the home currency column, less the market value in home currency of foreign money on hand, represents the profit or loss for each account. For instance, if a New York bank purchases £100 of Bank of England notes at the rate of $4.75 and a week later sells £20 at $5.00 to a person who is going to London, the ledger account with the English currency will appear as follows:

<table>
<thead>
<tr>
<th>Foreign Currencies, Pounds Sterling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased</td>
</tr>
<tr>
<td>@4.75</td>
</tr>
</tbody>
</table>
The difference between the debits and credits of the home currency column is $375. Assume that the exchange rate at the close of the period is $4.95; then the value of pounds sterling on hand, £80, is $396. A profit of $21 ($396 - $375) results. It is customary to close the account out and take the profit or loss into account at the end of the fiscal period.

Cable Transfers - A cable transfer is essentially the same as a telegraphic transfer of money. The banks in the home country, upon receipt of the money, will cable the banks abroad to pay a certain amount to the party designated by the remitter. For instance, a New York manufacturing company wants to send £5,000 to its London purchasing agent to buy a certain kind of raw material urgently needed for production. Assume that the current rate for cable transfers to London is $5.05 and that the cable expense is $15. After the bank is paid $25,265 ($25,250 for the £5,000 purchased and $15 for cable expense) by the New York manufacturing company, the bank will cable its London correspondent bank, with whom it maintains a pounds sterling account, to pay the agent of the New York company. The journal entry on the bank's books will be:

Cash..................$25,265

Due from Foreign Banks & Bankers (Name of London correspondent) $25,250

Cable Expenses............... $15

It must be noted that the Cash account and the Cable Expenses
account have dollar amounts only, while the Due from Foreign banks and Bankers account has both foreign currency units and dollars, or home currency.

In case the exchange is handled through dealers, or brokers, the broker customarily receives a compensation in the form of a brokerage fee. These fees are journalized as is any expense. They are charged to the Foreign Exchange Brokerage account. Credit for the amount involved would be made to a special account payable kept for each broker with whom the bank does business. They are usually paid semi-monthly or monthly. After the cable is sent to its London correspondent, the bank must also confirm the

Illustration VIII

Cable Confirmation Form

The Foreign Exchange Bank
New York, N. Y.
U. S. A.

To

Date

Dear Sirs:

We herewith confirm our cable today, requesting you to charge our account and effect the following payment, for account of ____________________________.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount</th>
</tr>
</thead>
</table>


cable transfer by mail. It often happens that a cable is mutilated in transmittal, but a mail confirmation, while powerless to stop the payment, may help to straighten out differences. A cable confirmation is shown on page 125.

Mail Transfers. The recording of a mail transfer is somewhat similar to that of a cable. A mail transfer is an order upon a foreign correspondent to pay money to a certain person for the account of another person in the home country. From the viewpoint of the buyer, if there is no urgent need, the money can be sent by mail instead of cable in order to save the cable expenses. Furthermore, the rate of mail transfer, like that of demand drafts, is lower than the cable rate, because the bank has the use of its credit balance abroad until the time when the mail transfer reaches its destination abroad. The use of mail transfer is very common for private and personal payments abroad, but less common for commercial settlements. As in the case of cables, letters of advice, as previously shown, are sent to the foreign correspondent, giving the details necessary for making the payments. But the journal entry for the mail transfer is different from that of the cable transfer:

Cash..........................$_____

Remittances - Mail Transfers... $_____

After a certain limit of time, when the mail transfer is

1Letter payment or delegation is also used by some of the banks for mail transfer cf. R. B. Kester, Accounting Theory and Practice, Vol. III, p. 67.
about to be paid by the London correspondent, the following entry is passed:

\[
\text{Remittances - Mail Transfers} \quad \$\quad \\
\text{Due from Foreign Banks & Bankers} \quad \$\quad \\
\text{(Name of London correspondent)}
\]

The Remittances account is introduced to record the foreign exchange sold but unpaid.

**Demand Drafts** - A large volume of exchange sales is done through the medium of demand drafts, or sight drafts, drawn by the bank in the domestic country on its correspondent abroad. These drafts are drawn in foreign currency - pounds sterling, francs, marks, pesos, etc. - on the foreign correspondent and charged by the latter against the deposits which the domestic bank maintains abroad. The drafts are drawn either single or in duplicate. When it is issued in duplicate, the first is called the "First of Exchange," and the second, the "Second of Exchange." They are mailed at different times to catch different steamers in order to avoid loss, but whichever draft is first presented to the correspondent is paid. Care must be taken by the correspondent not to pay the same draft twice, and the domestic bank likewise must be careful, in checking the letters of advice received from its correspondent, not to be charged twice for the same draft. At the time when the demand draft in foreign

\[2\text{L. H. Langston, Bank Accounting Practice, p. 154.}\]
currency is sold, the journal entry is:

Cash.................. $____
Remittances - Demand Drafts..... $____

The Cash account has dollar amounts, or home currency, only, the Remittances account has both foreign currency units and home currency. When the draft is about to be paid by the correspondent upon the presentation by the receiver abroad, the following entry is journalized:

Remittances - Demand Drafts.......$____

Due from Foreign Banks & Bankers $____
(Name of London correspondent)

As a rule the domestic bank sends its foreign correspondent a letter of advice, as follows, after the draft is issued.

Illustration IX

Advice Form for Demand Drafts Issued

The Foreign Exchange Bank
New York, N. Y.
U. S. A.

To______________ Date__________

Dear Sirs:

We have taken the liberty to draw on you today the following checks which we request you to honor and charge to our account.

<table>
<thead>
<tr>
<th>Check No.</th>
<th>Payable to</th>
<th>Amount</th>
</tr>
</thead>
</table>


Travelers' Letters of Credit - To enable travelers to avoid carrying large sums of cash when abroad, most foreign exchange banks and bankers issue travelers' letter of credit. These may be issued either against cash payment by the customer or against the customer's liability. If the customer pays cash for his Travelers' Letters of Credit, the entry will be:

Cash.......................... $_____

Deposits Against Travelers' Letters of Credit...........$_____

So long as the letter of credit is not fully used by the traveler, the obligation of the bank will stand. These letters of credit will be honored by the foreign correspondents of the domestic bank and will be charged against the balance of the domestic bank. If the traveler presents the letter of credit at the London correspondent's office, it pays pounds sterling to the traveler and charges the domestic bank which issued the letter of credit. When the London bank advises the payment, the domestic bank will pass the following entry to reduce its obligation under travelers' letter of credit and to credit its London correspondent with the payment at the rate of exchange current on the date of presentation of the draft.

Deposits Against Travelers' Letters of Credit................$_____

Due from Foreign Banks & Bankers
(Name of London correspondent) $_____

---

If the customer is well known to the domestic bank, he may not pay cash immediately, the traveler's letter of credit may be issued on credit. The entry is:

Customers' Liability under Travelers' Letters of Credit
Travelers' Letters of Credit Issued

Foreign exchange banks usually issue, also, travelers' checks to their customers instead of travelers' letter of credit. The entries are simpler since these checks are issued only against cash. The entry at the time of issuing is:

Cash
Travelers' Checks Outstanding

When these checks are presented and paid by the foreign banks, the following entry is made after the receipt of advice of payment from foreign correspondents.

Travelers' Checks Outstanding
Due from Foreign Banks & Bankers
(Name of the correspondent)

Commercial Letters of Credit - A commercial letter of credit is "an instrument issued by a bank at the request of a buyer of goods whereby the bank itself undertakes to accept or pay drafts drawn upon it by the seller of the merchandise concerned."4 A great volume of foreign exchange business is carried on through the medium of

commercial letters of credit, because a letter of credit provides a means of substituting bank credit for merchantile credit and gives the exporter more security of payment. The accounting procedure for a commercial letter of credit transaction is illustration as follows. Assume that a New York merchant dealing in tung oil has arranged a purchase with a Shanghai merchant, either by cable, by mail, or by purchasing agent. Having made the arrangements as to terms, the New York merchant goes to his bank and requests the issuance of a letter of credit. The foreign exchange bank has two ways to handle this request. If the credit standing of the New York merchant is high and sound, an unsecured credit may be granted; otherwise, the New York merchant may be requested to deposit cash or collateral in the form of securities to be held by the bank during the life of the credit. The beneficiary of this letter of credit is the Shanghai merchant, and the bank will accept the drafts drawn on itself by the Shanghai merchant provided the shipment and the draft confirm to the requirements set forth in the letter of credit. Generally the bank will demand that the draft presented for acceptance must be accompanied by shipping documents, bills of lading, consular invoices, marine insurance certificates, etc. The New York merchant is now able to take the shipments by signing a 'trust receipts' to the bank and place the merchandise on the market for sale, but the bank retains a lien upon the merchandise until the draft is paid by the New York
merchant. The journal entries for a commercial letter of credit transaction are illustrated below:

(1) When the bank issues the letter of credit for the account of the New York merchant, it creates a contingent liability which at any time may become a real liability. The contingent liability arises from the agreement by the bank to allow the merchant the use of the credit standing of the bank, and the real liability arises when the Shanghai merchant presents his draft and shipping documents to the bank for acceptance. In order to record the contingent liability on the bank's books, the following is made through the books; to record the obligation of customers to reimburse the bank for engagements to pay or accept commercial bills of exchange and to show the contingent liability of the bank arising from engagements to pay or accept commercial documents.

Customers' Liability under Letters of Credit
Commercial Letters of Credit Issued

(2) When the draft is accepted by the bank, the contingent liability is extinguished and the real liability comes into existence. The following entries are made:
(a) To reverse the transaction of contingent liability as the draft is presented to the bank and the
letter of credit is exhausted.

Commercial Letters of Credit Issued..................$_____

Customers' Liability under Letters of Credit.............$_____

(b) To record the obligation of customers to reimburse the bank for commercial drafts accepted payable at a future date and to show the bank's liability through acceptance of a draft against foreign shipments of merchandise.

Customers' Liability on Acceptances under Letters of Credit...............$_____

Acceptances.....................$_____

At the same time the acceptance is entered in the acceptance register. The function of this book is to provide complete information about each acceptance from the time of acceptance until final payment. There are columns for number, date, amount, maturity date, drawer, address of drawer, commercial letter of credit number, for whose account, by whom presented, nature of the shipments, discounts, and payment.

(3) When the due date of the acceptance approaches, the New York merchant, probably having already sold his merchandise, goes to his bank to make the payment.

The entry is:
After the payment is received, the bank sends a letter of advice to its Shanghai correspondent bank requesting the Shanghai bank to pay the Shanghai merchant the amount of his draft which was accepted by the New York bank. The entry is:

Cash........................................$._____

Customers' Liability on
Acceptances under
Letters of Credit............$._____

Acceptances by Foreign Correspondent* •••***•••••••**• $,

Due from Foreign Banks & Bankers $_____
(Name of Shanghai correspondent)

(4) It may occur that the draft, drawn under the letter of credit issued by the New York bank, is accepted by its correspondent bank in Shanghai. In this case the New York bank, upon advice from the Shanghai bank to accept the draft, will charge the customer for whose account the draft was accepted and credit the account, Acceptances by Foreign Correspondent.

Customers' Liability on
Acceptances under
Letters of Credit................$._____

Acceptances by Foreign Correspondent................ $_____

At maturity the New York merchant pays the New York bank; thus, the customer's liability is cancelled. The journal entry will be:
Cash....................$_____

Customers' Liability on
Acceptances under
Letters of Credit........... $_____

The New York bank will send a letter of advice to
its Shanghai correspondent asking to charge its
account with the Shanghai bank, and pass the
following entry:

Acceptances by Foreign
Correspondent..................$_____

Due from Foreign Banks & Bankers $_____
(Name of Shanghai correspondent)

Forward Sales⁵ – The New York merchant knows that
the payment of the shipments from Shanghai will be due at a
certain time later; as the exchange rate of the Chinese
dollar fluctuates considerably, he can avoid the exchange
risk by purchasing Chinese dollars forward from his New York
bank deliverable at the time when the draft matures. These
transactions contemplate both delivery and payment at a future
date. Special accounts are introduced for these transactions.
The following entry will be on the books when the contract of
purchase is made:

Accounts Receivable –
Foreign Exchange Sales.........$_____

Exchange Future Sold........... $_____

⁵A. Van Oss, "Covering Exchange Risks....." The
Journal of Accountancy, Vol. 46, November, 1928, pp. 331-345;
December, 1928, pp. 426-439.
When the draft is due, the New York merchant pays the bank for the Chinese dollars at the rate of the contract, and the bank will, in turn, ask its correspondent bank in Shanghai to pay the Shanghai merchant the amount of Chinese dollars drawn by the draft. On the books of the New York bank, the following entries are made:

(1) To record the receipt of the payment from the New York merchant for the purchase of Chinese dollars to cover the draft drawn under the commercial letter of credit.

Cash..............................................$_____

Accounts Receivable -
Foreign Exchange Sales............ $_____

(2) To record the payment of the draft under commercial letter of credit through the Shanghai bank.

Exchange Future Sold..................$_____

Due from Foreign Banks & Bankers $_____
(Name of the Shanghai bank)

Exchange Purchases

Foreign Currencies - Foreign travelers, after leaving their own country, may still have some home currency in their hands; and persons working in the offices of both foreign agencies and foreign embassies may receive payments in foreign currencies. As a rule, no foreign currency can circulate as does home currency; persons who have foreign
currencies have to go to the foreign exchange bank and convert them into domestic currency before they can pay their bills and expenses. The exchange rate of foreign currencies is based on the current exchange rate also on the local demand for and supply of this kind of foreign currency. The journal entry for purchasing foreign moneys is shown below:

Foreign Currencies ................. $_____
(Pounds Sterling)

Cash ..................... $_____

It will be noted that the account for foreign currencies is kept in both foreign units and home currency.

Collections - Foreign collection is just like domestic collection. The bank receives coupons of foreign bonds from its customers, and sends them to its foreign correspondent bank for collection. After the proceeds are available abroad, the bank makes settlement with the customers. The proceeds collected are usually in foreign currency and credited to the bank's account by the correspondent bank abroad, but the bank pays home currency to its customers according to the current rate of exchange. It is, therefore, a transaction of exchange purchase. Generally, the customer has to pay collection charges twice if the collection items are drawn in home currency, because, in this case, the bank will have no opportunity to purchase foreign exchange collected at a lower rate. A foreign collection involving a dollar item appears as follows:
Face of the item.............$10,000
Foreign correspondent's charges..................... 10
Funds available abroad........ $9,990
Domestic bank's charge....... 10
Amount available for customer...................... $9,980

But, if the collection item is in pounds sterling, and, if at the time the proceeds are collected, the bank's buying rate for the pound is $4.90, the collection transaction will appear as follows:

Face of the item............. £2,000
Foreign correspondent's charges..................... 2
Funds available abroad........ £1,998

At the exchange rate $4.90... $9,790.20

The balance $9,790.20 is the amount available to the customer; there is no additional charge by the domestic bank, since it has the advantage of buying the proceeds at the bank's buying rate which is generally lower than the market rate. After the calculation, the journal entry will be:

(1) for the first case, the collection item is in home currency and no foreign currency is involved.

Due to Foreign Banks & Bankers......$9,990

Cash.......................... $9,980
Commission - Collection Charges. $10

The Due to Foreign Banks and Bankers (Loro) account is kept only in home currency, and there is no conversion involved.

(2) For the second case, the collection item is in
pounds sterling. The proceeds of £1,998 collected abroad is credited to the account of the domestic bank by its London correspondent, but the domestic bank pays its customer in home currency at the bank's buying rate of pounds sterling.

Due from Foreign Banks & Bankers...$9,790.20
(Name of London correspondent)

Cash............................... $9,790.20

It will be noted that the Due from Foreign Banks and Bankers (Nostro) is kept in both pounds sterling and American dollars. The date, the collection number, the collection charges by the correspondent bank, the proceeds in pounds sterling, and the exchange rate, all should be entered in the proper column on the Nostro account.

Discounts 6 — In the case of discount, the bank pays the customer for the item at the time of receipt, and reimburses itself later when the collection has been effected abroad. In practice the term discount usually refers to items drawn payable in home currency. The bank pays the customer the face amount of the bill less interest for the time between the date of discount and the date of final payment abroad. An illustration is needed for explanation. Assume that a customer presents a foreign bill for $20,000 (United States currency) payable 90 days hence in Shanghai, and that the rate of discount is 3%. The proceeds of this

bill would be $20,000 less interest at 3% for 90 days, or $20,000 less $150, net amount $19,850, which is the amount the customer would receive.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face of the bill</td>
<td>$20,000</td>
</tr>
<tr>
<td>Discount @3% for 90 days</td>
<td>150</td>
</tr>
<tr>
<td>Proceeds</td>
<td>$19,850</td>
</tr>
</tbody>
</table>

After the bank has acquired the bill through discount, it sends the bill to the Shanghai correspondent for collection. The Shanghai correspondent bank will send advice of payment to the American bank informing it that the proceeds are collected and credited to its account. The American bank will then make a journal entry to complete the discount transaction and settle the account with the Shanghai bank.

The journal entries for the whole transaction are shown below:

1. At the time of discount

   - Bills Discounted - Foreign...$20,000
   - Interest - Foreign Bills Discounted...$150
   - Cash...$19,850

2. When the advice of payment is received from the Shanghai correspondent

   - Due to Foreign Banks & Bankers...$20,000
   - Bills Discounted - Foreign...$20,000

Advances - A bank may also make advances to their customers who present to the bank their foreign bills. In
this case the bank pays the owner of the bill a part of the face amount an will make final settlement with the customer after the proceeds are collected abroad. For example, if a customer presents a foreign bill for $20,000 in United States currency, payable 30 days hence in Shanghai, the bank pays the customer $19,000, balance to be adjusted when the bank receives advice of payment from its Shanghai correspondent.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face of the bill</td>
<td>$20,000</td>
</tr>
<tr>
<td>Amount advanced</td>
<td>19,000</td>
</tr>
<tr>
<td>Amount retained</td>
<td>1,000</td>
</tr>
</tbody>
</table>

The journal entry will be:

- **Bills Discounted - Foreign** $20,000
- **Funds Retained - Foreign Bills** $1,000
- **Cash** $19,000

Later the Shanghai correspondent sends an advice of payment informing the bank that the proceeds are collected and credited to the American bank's account. Assume that the collection charges for the Shanghai bank are 0.5% and for the American bank, 0.25%. The customer will get another payment from the American bank for $850.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face of the bill</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: Charges for Shanghai Bank</td>
<td>100</td>
</tr>
<tr>
<td>Proceeds collected abroad</td>
<td>$19,900</td>
</tr>
<tr>
<td>Less: Charges for the American bank at 0.25%</td>
<td>$50</td>
</tr>
<tr>
<td>Amount advanced</td>
<td>19,000</td>
</tr>
<tr>
<td>Balance due</td>
<td>850</td>
</tr>
</tbody>
</table>
The journal entry for completing the advance transaction are shown below:

(1) To charge the account of the Shanghai correspondent for the collection collected

Due to Foreign Banks & Bankers.....$19,900
Commission - Collection Charges.... $100
Bills Discounted - Foreign..... $20,000

(2) To record the payment of the balance due to the customer after the collection charges are deducted

Funds Retained - Foreign Bills..... $1,000
Commission - Collection Charges. $150
Cash............................ $350

Purchases of Foreign Bills - When a customer presents to the bank a foreign bill drawn payable in foreign currency, the bank pays the customer the face amount in home currency at the prevailing rate of exchange. It is, therefore, a purchase instead of a discount or an advance; the bank becomes the owner of the bill, not an agent of the customer. For instance, a customer presents a London draft for £1,000 to a New York bank for sale. Assume that the bank's buying rate for pounds sterling is $4.85; the bank purchases the bill by paying the customer $4,850, and sends the bill to its London correspondent for collection. After two weeks, an advice of payment is received by the American bank from the London bank notifying it that the proceeds have
been collected and, after £2 are deducted for collection charges, the balance, £998, is credited to the American bank's sterling account. The journal entries for the whole purchase transaction are shown below:

(1) At the time when the purchase is made:

Bills Discounted - Foreign...........$4,850.00
Cash.................................... $4,850.00

(2) When the advice of payment is received from the London correspondent:

Due from Foreign Banks & Bankers....$4,840.30
(Name of London correspondent)
Commission - Collection Charges...... $9.70
Bills Discounted - Foreign.......... $4,850.00

It will be noted that the amount entered in the pounds sterling column on the Nostro account is £998, and the exchange rate for this transaction is $4.85.

**Commercial Letters of Credit** - For exporters the operating process of the commercial letters of credit is reversed, as compared with the illustration for importers. The duties of the importer's bank are the issuance of credit, releasing documents to importers, collecting from importers, and settling with foreign banks which make payments and accept drafts under this bank's commercial letters of credit. On the other hand, the activities of the exporter's bank include receiving advices from abroad that credits have been opened, informing the exporter that credits have been
arranged and the terms of sales, making purchases of the bills or making advances to exporters, and obtaining reimbursement from the importer's bank abroad. The exporter's bank acts as paying, negotiating, and accepting agent in connection with the commercial letters of credit of the importer's bank. Therefore, a contingent liability arises, as soon as the exporter's bank receives advices that the commercial letter of credit is opened. This contingent liability is an obligation to purchase draft or to create acceptances as the exporter avails himself of his credits. When the exporter's bank purchases the draft, the contingent liability is extinguished. In general practice, this contingent liability is not taken into account, but a definite record is kept with the details of the credits opened by each foreign correspondent bank and the outstanding balances which represent the contingent liability of the exporter's bank. At the time when the shipment of merchandise is ready, the exporter presents the draft or bill of exchange, which is drawn on the importer's bank abroad, together with the whole set of documents, such as bills of lading, invoices, marine insurance certificates, consular invoices, etc. to his bank for sale. Since the draft is drawn in foreign currency, the bank will purchase it at the current rate of exchange. The journal entry will be:

(1) To record the purchase of a foreign draft:
Acceptances Purchased - Foreign.. $______
(Name of the Correspondent)

Cash............................ $______
(To record the reimbursement from the foreign correspondent:

Due from Foreign Banks & Bankers....$______
(Name of the Correspondent)

Acceptances Purchased - Foreign.. $______
(Name of the Correspondent)

**Forward Purchases** - An exporter may expect to ship goods abroad at some future time after becomes the beneficiary of the commercial letter of credit issued by the importer's bank abroad; he may also expect to wait for 30, 60, or 90 days before payment after his draft is accepted by the importer's bank. If the exchange rate fluctuates rapidly during the long period of waiting, the exporter may wish to know definitely what he will realize on drafts which he expects to draw; he goes to the foreign exchange bank and sells foreign exchange for future delivery. When the time comes to ship the goods and draw drafts against the shipment, he will be able to sell the drafts at a fixed price already agreed upon. Assume that a New York exporter is going to ship goods to London under a commercial letter of credit issued by an English bank in London. The draft which he is going to draw on the English bank is estimated to be £5,000. He can sell £5,000 to his bank for future delivery at the current forward exchange rate, say $5.05, which he thinks is
favorable. The journal entry on the bank's books will be:

Exchange Future Purchased.............$25,250
Accounts Payable - Foreign
Exchange Purchases............... $25,250

The bank is able to assume the risk of fluctuation in exchange because of its superior knowledge of trends of exchange rates and because of the possibility of hedging the purchase. One month later, the exporter presents the draft and also its shipping documents to the bank for sale. The bank will purchase his draft at the fixed rate, $5.05, already agreed upon under the former contract. The exporter will receive $25,250 cash from the bank. The entries on the bank's books are shown below:

(1) To record the payment to the New York exporter for the forward purchase of £5,000 at $5.05.

Accounts Payable - Foreign
Exchange Purchases...............$25,250
Cash................................. $25,250

(2) To record the purchase of the bills of exchange drawn under the commercial letter of credit issued by the English bank.

Acceptances Purchased - Foreign.....$25,250
(Name of the Correspondent)

Exchange Future Purchased............. $25,250
CHAPTER IX

FOREIGN EXCHANGE ACCOUNTING FOR FOREIGN EXCHANGE BANKS - TRADING TRANSACTIONS

Besides handling the constant commercial transactions of buying and selling foreign exchange in connection with the business dealings of the customers, the foreign exchange banks customarily participate in the world exchange market, buying and selling foreign exchange in the open market as it is offered or demanded, for the purpose of making profit through the fluctuations of exchange rates at different times and places. Dealings of this type constitute the trading transactions for foreign exchange banks; they include the following items:

1. Exchange Arbitrage
2. Three-point Exchange Arbitrage
3. Interest Arbitrage
4. Gold Arbitrage
5. Speculation
6. Investment in Foreign Securities

The person who handles the trading transactions is known as a foreign exchange trader, and he is the most important factor in the work of the foreign exchange depart-
ment. The must be a man of wide experience in foreign exchange transactions, quick to see a favorable turn of the market, ready to take advantage of the rapid fluctuations of the market, and able to follow up his decisions with acts profitable to the bank. The trader is equipped with a large number of telephones and also special lines directly connected with the foreign exchange brokers, who are the intermediaries between banks and bankers wishing to buy or sell foreign exchange and also between the business concerns and the bank. The broker keeps in constant touch with the market for the different kinds of exchange, and is thus able to quote rates of exchange to the bank at any time. However, some of the large banks are coming more and more to deal directly with one another; and business men who want to buy or sell foreign exchange to directly to their banks instead of employing the brokers as middlemen. The trader, therefore, is the center of all foreign exchange transactions and is the one who makes the decision and sets up the exchange rate of every foreign exchange transaction. Whether a foreign exchange bank is making a profit or not depends for the most part upon the skill of the trader. The chief principle of the trader's work is to buy foreign exchange at a rate lower than that at which it is sold. He prepares a memorandum of the details of the transaction, giving the

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tenor, amount, rate, time of delivery, and the name of the customer or broker for whom the deal is made; and then he turns it over to the clerical force in the foreign exchange office. The memorandum serves as a basis for the accounting entries required to record the transaction. Inasmuch as he is the purchasing agent and also the selling agent of a commercial house, the trader performs the tasks of both, and is instrumental in creating either profits or losses.

As a purchasing and selling agent, the trader has to know at any time during business hours whether he has sufficient balances to his credit in foreign banks to meet his drawings, and whether his balances abroad are so heavy that he can afford to sell foreign exchange in order to reduce them. The record which keeps him informed of these facts is known as the "position sheet," the function of which is to classify foreign balances and to show the actual balances on deposit in different countries. The method of making a position sheet begins with a classification of all purchases and sales of foreign exchange according to maturity dates, that is, according to the dates on which they will probably be entered in the books of foreign correspondents. The maturity dates of different transactions can be found by keeping a close record of the arrival dates of steamers, on

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which the advices and letters of each transaction are carried through the mail. The bank has a good idea of the time when the advices and letters will arrive abroad and will be entered in the books of foreign correspondents. Besides the mail lines which carry the advices and letters of transactions abroad, there are others which affect foreign balances. First, there are the purchases and sales of cable transfers, which are not forwarded by mail. They are not subject to classification, and they are entered directly into the position sheet. Then there are forward sales and forward purchases, which are classified according to their maturity dates and transferred to the position sheet as these dates arrive. It is, therefore, the purpose of the position sheet to show the approximate status of each foreign balance, both as it stands currently and as it will stand on each future date as outstanding contracts are completed.

Position sheets also have two classifications: the cable position sheet and the time position sheet. The function of the cable position sheet is to show the balance against which drawings may be made by means of cable transfers. Since a cable transfer drawn today must be paid today, the bank has to know approximately the balances of its accounts on the books of foreign banks at the same day, in order to determine if that balances large enough for the payment of the cable transfer. The balances show the status of the accounts as they should stand, provided all items in
transit reach their destination upon the estimated date, provided all outstanding contracts are completed on time, and provided no further transactions are entered. Thus the cable position sheet shows today's position. To carry today's closing balance forward and to add or to subtract tomorrow's debits and credits will be tomorrow's cable position. A cable position sheet form is shown on the next page.

The bank constantly draws sight drafts, thirty-day drafts, or sixty-day drafts; and also sells and purchases forward exchange deliverable thirty days, sixty days, or ninety days later. Therefore, the bank needs the time position sheet, such as sight position, thirty-day position, etc. The sight position is used to show the balance which will be available to meet sight or demand drafts by the time they arrive abroad and are presented at the office of the correspondent bank. A sight position of a given day for a certain account may be quite different from the cable position of the same day, because a sight draft drawn on London mailed today will not reach the London bank for payment until ten days later. For instance, if the cable position with a London bank today is £100,000, the balance on the sight position sheet ten days later is not £100,000, but £100,000 plus any credits that will be made within the next ten days and minus any debits. Therefore, the ten-day sight position of the account is today's cable position adjusted with items
Illustration X

Cable Position Sheet

<table>
<thead>
<tr>
<th>Foreign Correspondents</th>
<th>Balances</th>
<th>Overdrafts</th>
</tr>
</thead>
</table>

**Sterling accounts:**
- Barclays Bank, London.....
- Midland Bank, London.......  
- Westminster Bank,
  Liverpool....................

**French Franc accounts:**
- Banque de France, Paris....
- Banque Nationale Francaise du Commerce Exterieur,
  Paris.........................
- Banque Nationale Francaise du Commerce Exterieur,
  Marseille......................

**German Mark account:**
- Berliner Handels -
  Gesellschaft, Berlin.....

**Italian Lira account:**
- Banca d'Italia, Rome.......  

**Chinese Dollar account:**
- Bank of China, Shanghai....

**Brazilian Milreis accounts:**
- Banco do Brasil, Rio de Janeiro..................
in transit and other outstanding items which will affect the account within ten days. In the same manner, other position sheets are prepared.

By using exchange position sheets and also his thorough knowledge of the foreign exchange market, the trader makes profits for his bank mostly by arbitrage and speculation. The various types of arbitrage and speculation are discussed below.

**Arbitrage (or Two-point Arbitrage)**

Two-point arbitrage is the simplest form of arbitrage because it involves the currency of only two countries. It is based on the economic theory of one price, which states that the prices of any given standardized commodity in the several markets will tend to be the same, if the markets are closely linked by rapid communications and there is no barriers to trade between them. For instance, if the pound sterling rate in New York is different from the dollar rate in London because of the variations of local demand and supply, there is a great opportunity for profit through arbitrage transactions. Assume that sterling drafts sell in New York for $4.95, and dollar drafts sell in London at the rate of $4.93; the foreign exchange trader will take the chance immediately by ordering his London correspondent to sell cable transfers payable in dollars at $4.93 per pound and to credit the

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pounds sterling to his account. Simultaneously, he sells the same amount of pounds sterling at the New York market at the rate of $4.95, and he gains $0.02 per pound on this transaction. The trader can continue this arbitrage as long as the discrepancy between the rates exists, but, sooner or later, the arbitrage transactions will wipe out the discrepancy and make the rates in both markets the same. A typical arbitrage transaction and its journal entries are shown below:

New York

(1) Rate for sterling cable transfer - $4.95 per pound
(2) Sell £100,000 sterling cables for $495,000 at the New York market
(3) The $495,000 covers the London transaction with a gross profit of $2,000

London

(1) Rate for dollar cable transfer - $4.93 per pound
(2) Sell $493,000 dollars for £100,000 and deposit in the account with the London bank
(3) The £100,000 covers the New York transaction, the sale of £100,000 at New York market

In the above example, it is clear that the arbitrage transaction will bring the two rates in line by supplying pounds sterling in New York and American dollars in London. The arbitrage transaction, thus, will finally wipe out the discrepancy between the rates in the two markets. The journal entry on the New York bank's books will be:
(1) To record the sale of sterling cable on London at the New York market at the rate of $4.95:

Cash..............................$495,000
Due from Foreign Banks & Bankers. $495,000
(Name of London correspondent)

(2) To record the purchase of £100,000 sterling cable through London correspondent at the rate $4.93:

Due from Foreign Banks & Bankers....$493,000
(Name of London correspondent)
Due to Foreign Banks & Bankers... $493,000
(Name of London correspondent)

It will be noted that the profit $2,000 made from this transaction will be kept in the Nostro account until the end of the accounting period, at which time a profit and loss adjustment is made and it is transferred to the profit and loss account. The adjusting process will be explained later.

Three-point Exchange Arbitrage (or Three-cornered Arbitrage) - As international trade is not a simple two-sided matter between two countries, but involves a multitude of transactions in different currencies of many countries, it is highly improbable that the exchange of visible and invisible items between any pair of countries will be exactly equal. The United States may have an excess of exports to England; England may have an excess of export to France; and France may have an excess of exports to the United States. Under these circumstances the price for sterling bills will be relatively low in New York, that for bills in French
francs will be relatively low in London, and that for bills in American dollars will be relatively low in Paris. In such a case the New York foreign exchange trader would purchase cheap sterling drafts at New York market, utilize the pounds sterling to purchase French francs at London market, and then use the French francs to buy American dollars at the Paris market. This practice would continue until the rates of exchange became so adjusted as to yield no arbitrage profit. A typical three-point exchange arbitrage transaction and its journal entry are shown as follows:

New York

(1) Rate for sterling cable transfer - $5.00 per pound

(2) Rate for French francs cable transfer - $0.033 per franc

(3) Purchase £10,000 sterling cables for $50,000 at the New York market and deposit it in the sterling account with the London bank

London

(1) Rate for dollar cable transfer - $5.01 per pound

(2) Rate for French francs cable transfer - 151 francs per pound

(3) Purchase French francs 151,000 by utilizing the £10,000 cable from New York, and remit the 151,000 francs to the Paris correspondent

Paris

(1) Rate for sterling cable transfer - 150 francs per pound

(2) Rate for dollar cable transfer - $0.034 per franc

(3) Purchase American dollars $51,340 by using the 151,000 francs transferred from London at the rate of $0.034 per franc
It will be seen that the original capital for the three-point arbitrage is $50,000, but when the transaction is completed the capital is increased to $51,340. A gross profit of $1,340 is made. On the bank's books, the accounting records for the above transaction will be:

(1) To record the purchase of $10,000 sterling cable at the exchange rate of $5.00 from New York market:

Due from Foreign Banks & Bankers....$50,000
(Name of London correspondent)

Cash............................. $50,000

(2) To record the purchase of 151,000 French francs through the London correspondent and the transfer of the francs to the franc account with the Paris bank:

Due from Foreign Banks & Bankers....$50,000
(Name of Paris correspondent)

Due from Foreign Banks & Bankers. $50,000
(Name of London correspondent)

(3) To record the purchase of $51,340 through the Paris correspondent by using the 151,000 francs transferred from the London correspondent at $0.034.

**Interest Arbitrage** - The method of arbitrage can also be employed to make a profit by taking advantage of the discrepancy between the interest rate, instead of the exchange rate, of two countries. If short-term interest rates

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are higher in one country than in another, the forward market provides a medium by which money can be transferred from the low interest rate market to the high interest rate market, invested for a short period, and brought back without exchange risk. For example, if the New York 60-day money rate is 2% per annum and the 60-day rate in Paris is 3%, the New York bank can earn 1% more if the bank transfers its money to Paris. But before the bank transfers its money to Paris, the bank has to be sure about the exchange rate on American dollars 60 days later in Paris - that is, dollar cost more in terms of francs - the 1% gain in interest might be wiped out by an exchange loss. This exchange risk, however, can be avoided by a swap transaction. At the time when the francs purchased are invested for 60 days, the New York bank can sell the same amount of francs for 60 days future delivery. Therefore, 60 days later when the short-term investment matures, the New York bank collects the francs and deliver them to the customer, to whom the bank has sold, and so recovers American dollars at a fixed rate. But there is another factor to be considered. If the discount on forward francs is 1% or more, the profit from the interest arbitrage is wiped out. If the rate on forward francs is identical with the spot rate (the purchase rate), the one per cent gain will be the gross profit of the arbitrage. An illustration is given below based on the assumptions that:
(1) the 60-day money rate in New York is 2% per annum  
(2) the 60-day money rate in Paris is 3% per annum  
(3) the French francs cable transfer rate is $0.035 per franc  
(4) the French francs 60-day rate is $0.034975 per franc  

The exchange trader would purchase 2,000,000 French francs at the rate of $0.035, or the equivalent of $70,000 American dollars, and invest the francs in the Paris short-term money market; simultaneously, he would sell 2,010,000 French francs deliverable 60 days later at the rate $0.034975. After 60 days the short-term loan in Paris is due, and the investment has earned interest of 10,000 francs, on 2,000,000 francs for 60 days at 3% per annum. Then, the trader would sell the francs according to the contract of forward sale at the rate $0.034975, and he would get back $70,299.75 American dollars. The interest earned from this transaction is $299.75, compared with $233.33, which is 2% per annum of $70,000 for 60 days, if the amount is invested in the New York money market. The gross gain from this transaction is $66.42. The journal entries on the bank's books will be:

(1) To record the purchase of two million French francs at the rate of $0.035:

Due from Foreign Banks & Bankers...$70,000  
(Name of Paris correspondent)  
Cash................................. $70,000
(2) To record the forward sale of French francs 2,010,000 at 60-day rate $0.034975:

Accounts Receivable - Foreign
Exchange Sales........................$70,299.75
(French Francs)

Exchange Future Sold............... $70,299.75

(3) To record the short-term loan in Paris money market, through the Paris correspondent, for 2,000,000 francs:

Foreign Investment -
Short-term .......................$70,000.00

Due from Foreign Banks & Bankers. $70,000.00
(Name of Paris correspondent)

(4) To record the receipt of the payment of the loan and its interest at 3% per annum on 2,000,000 francs for 60 days:

Due from Foreign Banks & Bankers....$70,299.75
(Name of Paris correspondent)

Foreign Investment - Short-term.. $70,000.00

Interest Earned - Foreign....... $299.75

(5) To record the sale of the 2,010,000 francs as per contract at the rate $0.034975:

Cash..........................$70,299.75

Exchange Future Sold..........$70,299.75

Accounts Receivable - Foreign
Exchange Sales....................... $70,299.75
(French Francs)

Due from Foreign Banks & Bankers. $70,299.75
(Name of Paris correspondent)
Gold Arbitrage - In addition to exchange and interest arbitrage, there is a third kind of arbitrage - gold arbitrage, which can be operated only between countries both with some degree of freedom in the export and import of gold. One country may have a free gold market and allow the export and import of all gold, and the second country may permit gold import only for immediate sale to the treasury; then the gold arbitrage will operate only from the gold market to the treasury, but not in the reverse direction. England and the United States are good examples of this combination. Since 1934, the United States Treasury has stood ready to buy all gold imported at $35 per ounce; in England there has been a free gold market. Assume that the exchange rate for pounds sterling in New York is $5.00 per pound, and the price of gold in London is £6. 18s. per fine ounce. Under these conditions a New York foreign exchange trader would buy sterling to purchase gold in London, because £6. 18s. at the exchange rate of $5.00 is the equivalent of $34.50 with which the trader could buy an ounce of fine gold at the London gold market. The trader makes $0.50 gross profit per ounce of gold purchased. Suppose that two thousand ounces of gold are purchased in London and the charges (freight, interest, and insurance) for transportation from London to New York are 25 cents per ounce. The complete transaction and its journal entries on the books of the bank will be shown as follows:

5Ibid., pp. 108-111.
(1) To record the purchase of £13,800 at the rate of £5.00 per pound:

Due from Foreign Banks & Bankers....$69,000
(Name of London correspondent)

Cash...........................................$69,000

(2) To record the purchase of 2,000 ounces of fine gold through the London correspondent at £6. 18s. per ounce:

Gold Shipments.........................$69,000

Due from Foreign Banks & Bankers. $69,000
(Name of London correspondent)

(3) To record the sale of the 2,000 ounces of gold to the United States Treasury at $35 per ounce:

Cash...........................................$70,000

Gold Shipments..........................$70,000

(4) To record the transportation charges paid in cash for the 2,000 ounces of fine gold, at 25 cents per ounce:

Expenses - Gold Shipments.......... $500

Cash...........................................$500

It will be seen that the net profit for this gold arbitrage transaction is $500, which is kept in the Gold Shipments account, just like other Nostro accounts.

Exchange Speculation - Another method by which the foreign exchange trader can make profits is by means of speculation on exchange, which is different from arbitrage.
transactions on account of the fact that there is no using of the forward market to cover a spot transaction. Whenever the trader thinks the exchange rate of pounds sterling is going to rise he buys future pounds sterling, hoping to be able to dispose of them at a better rate later. If he thinks the future course of the exchange rate of pounds sterling is going to be lower, in comparison with the current, he sells pounds sterling forward and hopes to be able to cover these sales at a lower rate later. The speculation transactions, therefore, are based on the trader's past experience in foreign exchange fluctuations and his skill in taking advantage of the opportunities in the exchange markets. For instance, in 1939, the exchange rate of pounds sterling averaged around $4.68 from February to July; then, because of war conditions in Europe, it dropped to $4.6107 in August; and $3.9951 in September. If a foreign exchange trader could forecast the drop of sterling rate three months beforehand, he would sell pounds sterling 90-day forward in July at the rate of $4.68, and wait until September when the rate dropped to $3.9951; then he would make a purchase at the lower rate to cover his former sale. He would gain $0.6849 profit on each pound in which he speculated. Suppose that the forward sale in July was £20,000, the whole transaction can be illustrated by the following journal entries.

Cf. Table I, on page 9.
(1) To record the sale of £20,000 90-day forward at the rate of $4.68:

Accounts Receivable - Foreign Exchange Sales..........................$93,600 (Pounds sterling)

Exchange Future Sold.................. $93,600

(2) To record the purchase of £20,000 in September at the rate of $3.9951 to cover the sale in July:

Due from Foreign Banks & Bankers.....$79,902 (Name of London correspondent)

Cash........................................... $79,902

(3) To complete the forward sale transaction in July by the receipt of cash and the disbursement through the London correspondent:

Cash............................................$93,600

Exchange Future Sold..................$93,600

Accounts Receivable - Foreign Exchange Sales......................... $93,600 (Pounds sterling)

Due from Foreign Banks & Bankers. $93,600 (Name of London correspondent)

The difference between the purchase and sale of the £20,000 is $13,698 ($93,600 - $79,902) which represents the gross profit of the speculation.

Foreign Investment - The foreign exchange banks may also invest money in foreign corporations, just as business men invest their money in stocks and bonds in their own countries, for the purpose of making profits. The accounting method for handling foreign investments has been
discussed in Chapter 6; therefore, it is not necessary to repeat it again here.

**Profits and Losses on Foreign Exchange Transactions**

It has been mentioned several times that the basic operating principle for foreign exchange banks or traders is to buy foreign exchange at the lowest possible price and to sell it at the highest possible price. Both the purchasing and selling transactions of foreign exchange are kept in the Due from Foreign Banks and Bankers (or Nostro) account, which is just like an old type merchandise account with the purchases on the debit side of the ledger and the sales on the credit side. The difference between the dollar amounts of total purchases and total sales is the gross profit or loss. The actual profits and losses, therefore, are kept in the Nostro accounts of pounds sterling, francs, marks, dollars, etc., with the various foreign correspondents. Only at the end of the accounting period, a profit and loss adjustment is made to find out the exact profit and loss during the period and to transfer it to profit and loss account. But the foreign exchange trader usually estimates the profit and loss on each Nostro account daily, in order to find out the result of his past trading operations during this accounting period. The method of determining profit and loss of each Nostro account is simple, and it is illustrated as follows. Assume that the current rate of pounds sterling at the time of the
The estimate is $4.80 per pound, and that the purchases and sales of pounds sterling are shown in the following ledger.

<table>
<thead>
<tr>
<th>Pounds</th>
<th>Rate</th>
<th>Dollars</th>
<th>Pounds</th>
<th>Rate</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase</td>
<td>10,000</td>
<td>4.75</td>
<td>47,500</td>
<td>Sale</td>
<td>1,000</td>
</tr>
<tr>
<td>&quot;</td>
<td>5,000</td>
<td>4.70</td>
<td>23,500</td>
<td>&quot;</td>
<td>10,000</td>
</tr>
<tr>
<td>&quot;</td>
<td>25,000</td>
<td>4.73</td>
<td>118,250</td>
<td>&quot;</td>
<td>20,000</td>
</tr>
<tr>
<td>Profit on Exchange</td>
<td>1,500</td>
<td></td>
<td>Balance</td>
<td>9,000</td>
<td>4.80</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
<td>190,750</td>
<td></td>
<td>40,000</td>
<td>190,750</td>
</tr>
<tr>
<td>Balance</td>
<td>9,000</td>
<td>4.80</td>
<td>43,200</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The total purchases of pounds sterling during the period amount to £40,000; and total sales, £31,000; the balance, £9,000. According to the current rate of $4.80 at the time of estimate, the dollar equivalent for £9,000 is $43,200, but the dollar balance is $41,700 (the difference between the total debits $189,250 and the total credits $147,550). Therefore, the current value of the £9,000 is $43,200, but its original cost is $41,700, and the difference of $1,500 is the profit made on sterling exchange transactions. At the end of the accounting period, the profits of all the Nostro accounts should be transferred to the profit and loss accounts, which are classified according to various foreign currencies. The
Following journal entry is used to show the transfer of the profit on sterling exchange to the Sterling Profit and Loss account.

Due from Foreign Banks & Bankers.... $1,500
(Name of London correspondent)

Sterling Profit and Loss........... $1,500
CHAPTER X

ACCOUNTING METHOD FOR AVOIDING EXCHANGE DIFFERENCES

Under the usual accounting practice, all foreign exchange transactions are registered in domestic currency and are accompanied by their equivalent in foreign currency in a special column of the subsidiary ledger accounts. For example, if an American importer purchases goods in England for £5,000 on 90 days' credit, at the time when he receives the goods he will record the transaction in American dollars as follows, assuming that the current exchange rate for pounds sterling is $4.75.

Purchases..........................$23,750

Accounts Payable.................. $23,750

The actual amount payable 90 days later, however, is not the figure $23,750 shown by this journal entry, but the £5,000 which is recorded in the foreign currency column of the Accounts Payable subsidiary ledger under the name of the English exporter. Assume that 90 days later the exchange rate has changed to $4.35, the actual amount payable is still £5,000; but, when it is expressed in American currency, it will be $24,250 instead of $23,750, as on the original record.
The exchange difference, thus incurred, is considered usually as the exchange profit and loss, and is journalized as follows.

Accounts Payable.............. $23,750
Exchange Adjustment............. $500
Cash.............................. $24,250

The loss of $500 on exchange is derived from the assumption that, at the time of purchase, the equivalent of 55,000 in American dollars is $23,750 which is set aside from the cash account for future payment; but at the time of payment the equivalent of 55,000 becomes $24,250 which is $500 more than the amount originally provided. The difference, $500, therefore, is a loss on exchange. But, in common practice, no business man would set aside his funds like this for accounts payable, because, first, it is not economical to tie up usable funds for a payment 60 or 90 days later, and, secondly, he usually does not have enough cash on hand for all accounts payable before the disposal of the merchandise he purchased. In this case, therefore, the amount, $23,750, credited to Accounts Payable at the time the purchase is made, is just a memorandum entry to show the increased liability. Actually, there is no cash involved, and, thereupon, the exchange difference of $500 is not a profit or loss item but an adjustment item to correct the original entry. Treating exchange differences as exchange profits or losses results in misrepresentation. Furthermore, if the exchange rates are subject to only slight fluctuations, the amount, $23,750,
credited to Account Payable account will be only an approximate statement of the £5,000 sterling obligation; but, if the exchange rates are subject to wide fluctuations, the amount, $23,750, will be a misstatement resulting from the fluctuation. It is therefore worth while to consider whether or not an accounting method can be established which will not only indicate the real obligation in foreign exchange transactions but will also simplify the recording of these transactions and avoid the differences resulting from exchange fluctuations.

The method employed to minimize the accounting for exchange differences is to record foreign exchange transactions in foreign currency units; that is, the transactions may be recorded in the currencies in which they take place. The variation in value owing to exchange rate fluctuation need not be recorded until actual conversion into domestic currency. For instance, if an American trading company is advised by bank in London that the American company's deposit account is credited with £50 as interest for the period. Under the usual accounting method, the American company would convert the £50 at the current rate of exchange into American dollars, and debit the account with the London bank and credit the Interest Received account, although the interest is received in sterling and still deposited in terms of sterling with the London bank. Under the suggested accounting method, however, the treatment is simpler, because
the transaction can be journalized in pounds sterling, as follows.

Deposits in the London Bank .......... £50
Interest Received ..................... £50

The general ledger, therefore, is divided into two parts; one for accounts kept in pounds sterling and one for accounts in American dollars. Inter-currency transactions are recorded in the Exchange account, which is operated throughout as a current account for the interchange from pounds to dollars, and from dollars to pounds. In other words, any transaction which involves sales or purchases of pounds sterling is recorded through the Exchange account, which is subdivided into two parts: the Dollar-Sterling Exchange account and the Sterling-Dollar Exchange account. For illustration, the new method can be applied to the same example given page 168. The journal entries on the American importer's book are as the following.

(1) When the purchase is made, the entry is recorded in sterling:

Purchases ......................... £5,000
Accounts Payable .................... £5,000

(2) When the draft is paid, in American currency:

Accounts Payable ..................... £5,000
$ - £ Exchange ......................... $24,250
£ - $ Exchange ......................... £5,000
Cash ...................................... $24,250
The amount $24,260, the equivalent of £5,000 at the current rate $4.35, is paid from the Cash account and debited to the Dollar-Sterling Exchange account; and, in turn, the actual amount payable, £5,000, is credited to the Sterling-Dollar Exchange account. The Exchange accounts serve as intermediate accounts for transactions which involve two currencies. It will be noted that there are two parts in the general ledger and two trial balances: one in pounds sterling and one in American dollars. As to closing entries, the following procedure should be followed:

(1) Close out all sterling assets and liabilities through Sterling-Dollar Exchange account, taking them up in the corresponding accounts in American dollars.

(2) Close out all sterling profit and loss items through Sterling-Dollar Exchange account, taking them up to the corresponding accounts in American dollars.

The illustration given below exemplifies the procedures which have been explained. Assume that an American trading company in New York has a sales agency in London, and that all agency transactions are recorded on the books of the home office. The following transactions occur during the period.

---

(1) A bank draft for £500 is purchased at the rate of $4.95 and is sent to the London agency as working fund.

(2) Fixed assets of £1,000 are purchased in London for the sales agency and paid by the home office by means of a sterling bank draft purchased at the rate $4.90.

(3) Total purchases of merchandise during the period amount to $500,000.

(4) Total domestic sales amount to $300,000.

(5) Total sales through the London sales agency amount to £50,000.

(6) Accounts Receivable collected from domestic sales amount to $250,000.

(7) Accounts Receivable collected from foreign sales amount to £45,000, which is converted into American dollars by selling to the foreign exchange bank in New York at the rate of $4.94.

(8) Accounts Payable paid for the period amount to $350,000.

(9) Total expenditures for the home office are:

   (a) Salaries..........................$25,000
   (b) Sales Commissions....................25,000
   (c) Advertising.........................10,000
   (d) General Expenses.....................20,000
(10) Total expenditures for the London sales agency are:
   (a) Salaries.................................. £2,000
   (b) Sales Commissions..................... 3,000
   (c) Advertising............................ 1,000
   (d) General Expenses...................... 2,000

   The total amount is £8,000 which is paid by the home office periodically. Assume that the average rate for purchasing pounds sterling during the period is $4.85.

(11) The closing inventory is $80,000, and the balance sheet of the home office before the establishment of the London sales agency is as follows.

   The American Trading Company
   Balance Sheet
   January 1, 19....

   Assets:                                      Liabilities
   and Net Worth:
   Cash.............. $25,000          Capital Stock...$50,000
   Fixed Assets...... 25,000

   $50,000

For the convenience of illustration, assume that the income and expenses of the home office and the London sales agency are not identified. The journal entries for the above transactions are shown as follows:
(1) To record the remittance to London agency at $4.95:

- London Agency Current.............. £500
- $ - £ Exchange.......................... $2,475
- £ - $ Exchange......................... £500
- Cash..................................... $2,475

(2) To record the purchase of fixed assets in London:

- Fixed Assets................................. £1,000
- $ - £ Exchange............................. $4,900
- £ - $ Exchange......................... £1,000
- Cash..................................... $4,900

(3) To record the purchases:

- Purchases.................................. $500,000
- Accounts Payable..................... $500,000

(4) To record the domestic sales:

- Accounts Receivable................. $300,000
- Sales..................................... $300,000

(5) To record the sales through the London agency:

- Accounts Receivable................. £50,000
- Sales..................................... £50,000

(6) To record the collections from domestic sales:

- Cash..................................... $250,000
- Accounts Receivable............... $250,000

(7) To record the collections from the London agency:
Cash ........................................... $222,300
£ - $ Exchange.............................. £45,000
$ - £ Exchange................................ $222,300
Accounts Receivable..................... £45,000

(8) To record the payments made on accounts payable:
Accounts Payable.......................... $350,000
Cash .......................................... $350,000

(9) To record the home office's expenditures:
Salaries....................................... $25,000
Sales Commissions......................... 25,000
Advertising.................................... 10,000
General Expenses........................... 20,000
Cash .......................................... $80,000

(10) To record the London agency's expenditures:
Salaries....................................... £2,000
Sales Commissions......................... 3,000
Advertising.................................... 1,000
General Expenses........................... 2,000
$ - £ Exchange................................ $38,800
£ - $ Exchange................................ £8,000
Cash .......................................... $38,800

After posting all these entries to the books, there are two trial balances available, shown on next page.
### The American Trading Company
#### Trial Balance - Pounds Sterling
June 30, 19....

<table>
<thead>
<tr>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>London Sales Agency Current</td>
<td>£500</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>£50,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Sales Commissions</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>General Expenses</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>$ - £ Exchange</td>
<td>35,500</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>£50,000</td>
<td>£50,000</td>
</tr>
</tbody>
</table>

### The American Trading Company
#### Trial Balance
United States Currency
June 30, 19....

<table>
<thead>
<tr>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$21,125</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td>$150,000</td>
</tr>
<tr>
<td>Capital Stocks</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>300,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Sales Commissions</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>General Expenses</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>$ - £ Exchange</td>
<td></td>
<td>176,125</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$676,125</td>
<td>$676,125</td>
</tr>
</tbody>
</table>
The closing entries are:

(1) To transfer sterling assets and liabilities through Sterling-Dollar Exchange account:

\[
\begin{align*}
\text{£ - $ Exchange} & \quad \text{£6,500} \\
\text{Cash} & \quad \text{£500} \\
\text{Accounts Receivable} & \quad \text{£5,000} \\
\text{Fixed Assets} & \quad \text{£1,000}
\end{align*}
\]

(2) The counterpart of entry (1), (Assume that the current rate of pounds sterling at the end of the period is $4.92.)

\[
\begin{align*}
\text{Cash (£500 \times $4.92)} & \quad \text{$2,460} \\
\text{Accounts Receivable (£5,000 \times $4.92)} & \quad \text{$24,600} \\
\text{Fixed Assets (£1,000 \times $4.90)} & \quad \text{$4,900}
\end{align*}
\]

\[
\begin{align*}
\text{£ - $ Exchange} & \quad \text{$31,960}
\end{align*}
\]

(3) To transfer revenue items through Sterling-Dollar Exchange account:

\[
\begin{align*}
\text{Sales} & \quad \text{£50,000} \\
\text{Salaries} & \quad \text{£2,000} \\
\text{Sales Commissions} & \quad \text{£3,000} \\
\text{Advertising} & \quad \text{£1,000} \\
\text{General Expenses} & \quad \text{£2,000}
\end{align*}
\]

\[
\begin{align*}
\text{£ - $ Exchange} & \quad \text{£42,000}
\end{align*}
\]

(4) The counterpart of entry (3) is shown below: (All revenue items are converted at the average rate $4.85, and the final difference on exchange con-
versions is charged to the Exchange Adjustment account.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>$9,700</td>
</tr>
<tr>
<td>Sales Commissions</td>
<td>$14,550</td>
</tr>
<tr>
<td>Advertising</td>
<td>$4,850</td>
</tr>
<tr>
<td>General Expenses</td>
<td>$9,700</td>
</tr>
<tr>
<td>$ - $ Exchange</td>
<td>$208,085</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$242,500</td>
</tr>
<tr>
<td>Exchange Adjustment</td>
<td>$4,385</td>
</tr>
</tbody>
</table>

After conversion, the consolidation of the two trial balances is shown as follows:

**The American Trading Company**
**Trial Balance**
**June 30, 19....**

<table>
<thead>
<tr>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$23,585</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td></td>
<td>74,600</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td></td>
<td>29,900</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Stocks</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>542,500</td>
</tr>
<tr>
<td>Salaries</td>
<td></td>
<td>34,700</td>
</tr>
<tr>
<td>Sales Commissions</td>
<td></td>
<td>39,550</td>
</tr>
<tr>
<td>Advertising</td>
<td></td>
<td>14,850</td>
</tr>
<tr>
<td>General Expenses</td>
<td></td>
<td>29,700</td>
</tr>
<tr>
<td>Exchange Adjustment</td>
<td>4,385</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$746,885</td>
<td>$746,885</td>
</tr>
<tr>
<td>Ending Inventory</td>
<td></td>
<td>$80,000</td>
</tr>
</tbody>
</table>
The home office in the United States then closes its books and prepares statements, as follows:

(1) To transfer purchases and expenses to Profit and Loss account:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and Loss</td>
<td>$618,800</td>
</tr>
<tr>
<td>Purchases</td>
<td>$500,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>$34,700</td>
</tr>
<tr>
<td>Sales Commissions</td>
<td>$39,550</td>
</tr>
<tr>
<td>Advertising</td>
<td>$14,850</td>
</tr>
<tr>
<td>General Expenses</td>
<td>$29,700</td>
</tr>
</tbody>
</table>

(2) To transfer sales and closing inventory to the Profit and Loss account:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$80,000</td>
</tr>
<tr>
<td>Sales</td>
<td>$542,500</td>
</tr>
<tr>
<td>Profit and Loss</td>
<td>$622,500</td>
</tr>
</tbody>
</table>

(3) To transfer the exchange gains to Reserve for Exchange Fluctuations account:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange Adjustment</td>
<td>$4,385</td>
</tr>
<tr>
<td>Reserve for Exchange Fluctuations</td>
<td>$4,385</td>
</tr>
</tbody>
</table>

The balance sheet and profit and loss statement are shown on next page.
The American Trading Company
Balance Sheet
June 30, 19...

Assets:

Cash ................... $23,585  
Accounts Receivable .......... 74,600  
Inventory ...................... 80,000  
Fixed Assets .................. 29,900  

Total  $208,085

Liabilities and Net Worth:

Accounts Payable ............ $150,000  
Reserve for Exchange  
  Fluctuations ................  4,335  
Capital Stocks ................. 50,000  
Profits ........................ 3,700  

Total  $208,085

The American Trading Company
Profit and Loss Statement
June 30, 19...

Sales ......................... $542,500  

Less Cost of Goods Sold:

  Purchases .................... $500,000  
     Less Inventory ............  80,000  420,000  

Gross Profit on Sales.........  $122,500  

Less Expenses:

  Salaries ..................... $34,700  
  Sales Commissions ..........  39,550  
  Advertising ................  14,850  
  General Expenses ..........  29,700  118,800  

Net Profit ...................  $3,700
As for the foreign exchange banks, the accounting method used to avoid exchange differences is somewhat dissimilar from what explained above, simply because the banks are dealers in foreign exchange. Their business is to purchase foreign exchange at the lowest rate possible and then to sell at the highest. The Exchange account for the foreign exchange banks, therefore, not only serves as an intermediate account for transactions which involve two currencies, but also as a merchandise account concerned with the profits and losses arising from the purchases and sales of foreign exchange. It is a combination of Dollar-Sterling Exchange account and Sterling-Dollar Exchange account into one account, in which eleven columns are ruled with the following captions:

(1) Date
(2) Explanation
(3) Debit
   (a) Sterling amount
   (b) Exchange rate
   (c) Dollar amount
(4) Credit
   (a) Sterling amount
   (b) Exchange rate
   (c) Dollar amount
The procedure of using the Exchange account can be illustrated by the following assumed transactions of a foreign exchange bank in New York City.

(1) To record the purchase of £30,000 cable transfer from another bank in New York at the rate of $4.90:

Due from Foreign Banks & Bankers... £30,000
Exchange Account.................. $147,000
Exchange Account................. £30,000
Cash................................ $147,000

(2) To record the purchase of £150 of sterling notes from an English tourist at the rate of $.480:

Foreign Currencies on Hand....... £150
Exchange Account.................. $720
Exchange Account............... £150
Cash................................. $720

(3) To record the sale of a demand draft on London for £300 at the rate of $4.93:

Cash................................. $1,479
Exchange Account................. £300
Exchange Account................. $1,479
Remittances - Demand Drafts..... £300
(4) To record the sale of £50 sterling notes to a customer over the counter at the rate of $4.90:

Cash.............................. $245
Exchange Account............... £50

Exchange Account.............. $245
Foreign Currencies on Hand...... £50

(5) To record the sale of £10,000 sterling cable transfer at the rate of $4.92:

Cash.............................. $49,220
Exchange Account............... £10,000

Exchange Account.............. $49,200
Cable Expenses.................. $20
Due from Foreign Banks & Bankers £10,000

(6) To record the forward sale of £5,000 to an importer in New York at the rate of $4.93:

Accounts Receivable - Foreign Exchange Sales............... $24,650

Exchange Account............... £5,000

Exchange Account.............. $24,650
Exchange Future Sold........... £5,000

(7) To record the purchase of a bill of exchange drawn on London for £1,000 at the rate of $4.89:

Bills Discounted - Foreign....... £1,000
Exchange Account............... $4,890

Exchange Account............... £1,000
Cash.............................. $4,890
(8) To record the collection of £2,000 through the London correspondent for account of an exporter in New York, at the rate of $4.90:

Due from Foreign Banks & Bankers... £2,000
Exchange Account.................. $9,800
Exchange Account.................. £2,000
Commission - Collection Charges.................. $30
Cash................................. $9,770

(9) To record the purchase of the bill of exchange drawn under the commercial letter of credit issued by the London correspondent for £1,000 at the rate of $4.88:

Acceptances Purchased - Foreign.... £1,000
Exchange Account.................. $4,880
Exchange Account.................. £1,000
Cash................................. $4,880

(10) To record the sale of £100 of travelers' checks to a customer at the rate of $4.95:

Cash................................. $495
Exchange Account.................. £100
Exchange Account.................. $495
Travelers' Checks Outstanding... £100

(11) To record the forward purchase of £1,000 from an exporter in New York at the rate of $4.90:
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange Future Purchased</td>
<td>£1,000</td>
</tr>
<tr>
<td>Exchange Account</td>
<td>$4,900</td>
</tr>
<tr>
<td>Exchange Account</td>
<td>£1,000</td>
</tr>
</tbody>
</table>

Accounts Payable - Foreign

Exchange Purchases

$4,900

The posting of above transactions in the Exchange account are shown in the illustration on next page.

It will be seen from the illustration that the Exchange account is a combination of the Sterling-Dollar Exchange account and the Dollar-Sterling Exchange account. Sales of sterling are entered in the debits column, and purchases of sterling are entered in the credits column. But the dollar equivalents of the sterling amounts in the debits column are the credit entries in the original Dollar-Sterling Exchange account; and the dollar equivalents of the sterling amounts in the credits column are the debit entries in the Dollar-Sterling account. Therefore, £19,700 is the credit balance for the original Sterling-Dollar Exchange account; and $96,121 is the debit balance of the original Dollar-Sterling Exchange account. The total purchase of sterling, £35,150, minus the total sale of sterling, £15,450, equals the sterling balance, £19,700, which is the inventory of pounds sterling on hand. The total costs of the purchases, $172,190, minus the total receipts of the sales of sterling, $76,069, equals the dollar balance, $96,121, which represents the cost of the sterling balance, £19,700. Hence,
Illustration XI

Exchange Account

<table>
<thead>
<tr>
<th>Date</th>
<th>Explanation</th>
<th>Debits (Sales of Sterling)</th>
<th>Credits (Purchases of Sterling)</th>
<th>Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Sterling Amount</td>
<td>Rate</td>
<td>Dollar Amount</td>
</tr>
<tr>
<td>(1)</td>
<td>Purchase</td>
<td>30,000</td>
<td>4.90</td>
<td>147,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Purchase</td>
<td>150</td>
<td>4.80</td>
<td>720</td>
</tr>
<tr>
<td>(3)</td>
<td>Sale</td>
<td>300</td>
<td>4.93</td>
<td>1,479</td>
</tr>
<tr>
<td>(4)</td>
<td>Sale</td>
<td>50</td>
<td>4.90</td>
<td>245</td>
</tr>
<tr>
<td>(5)</td>
<td>Sale</td>
<td>10,000</td>
<td>4.92</td>
<td>49,200</td>
</tr>
<tr>
<td>(6)</td>
<td>Sale</td>
<td>5,000</td>
<td>4.93</td>
<td>24,650</td>
</tr>
<tr>
<td>(7)</td>
<td>Purchase</td>
<td>1,000</td>
<td>4.89</td>
<td>4,890</td>
</tr>
<tr>
<td>(8)</td>
<td>Purchase</td>
<td>2,000</td>
<td>4.90</td>
<td>9,800</td>
</tr>
<tr>
<td>(9)</td>
<td>Purchase</td>
<td>1,000</td>
<td>4.88</td>
<td>4,880</td>
</tr>
<tr>
<td>(10)</td>
<td>Sale</td>
<td>100</td>
<td>4.95</td>
<td>495</td>
</tr>
<tr>
<td>(11)</td>
<td>Purchase</td>
<td>1,000</td>
<td>4.90</td>
<td>4,900</td>
</tr>
</tbody>
</table>
the Exchange account may be considered as a merchandise account, or as an inventory account. It records the details of purchases and sales of foreign exchange. The difference between the purchasing rate and the selling rate produces profits or losses. Assuming that the current rate of exchange of pounds sterling is $4.94, the profit and loss of the Sterling Exchange account can be estimated as follows:

<table>
<thead>
<tr>
<th>Sterling Balance (Cr.)</th>
<th>Dollar Balance (Dr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>£19,700</td>
<td>$97,318</td>
</tr>
<tr>
<td>(Current rate)</td>
<td>($4.94)</td>
</tr>
<tr>
<td>£4.8838</td>
<td>$96,121</td>
</tr>
<tr>
<td>(Cost)</td>
<td></td>
</tr>
<tr>
<td>Exchange profits........</td>
<td>$1,197</td>
</tr>
</tbody>
</table>

The examples given in this chapter deal only with pounds sterling and American dollars, but in practice a business concern may deal with as many as five or six foreign currencies. The accounting method employed to avoid exchange differences can be applied just as it was applied to pounds sterling in this chapter, through the establishment of a French Francs Exchange account, a Chinese Dollar Exchange account, etc.
In addition to the more or less normal fluctuations of exchange rates, there are two more serious problems in international trade with which foreign exchange accountants must reckon. Since 1931 the problems of currency depreciation and exchange control have made difficult the computation of accounts in international trade. The task of the accountant has thus been more complex.

In 1931, the depreciation of sterling that followed the suspension of the gold standard severely affected the interchange of currencies among all European and American countries. For years, the value of pound sterling had been used as a monetary standard on which the currency quotations of many other countries were based. After September 21, 1931, the value of sterling was uncertain. The entire financial structure, and particularly the financial structure in the sterling bloc, was thus shaken. Many countries, such as British India, British Malaya, Egypt, New Zealand, Palestine, Colombia, and Bolivia, followed the pound and
abandoned gold standard immediately.\textsuperscript{1}

More energetic policies of currency depreciation were adopted after the United States abandoned the gold standard in 1933.\textsuperscript{2} In October, 1933, the United States Reconstruction Corporation announced the gold purchase plan. The price of gold was raised from time to time.\textsuperscript{3} Finally, in January, 1934, the American dollar was legally reduced in weight by some 40 per cent and the policy of depreciation was crystallized.\textsuperscript{4}

Profit and loss on foreign exchange transactions was violently affected by the sudden change of exchange parities, as a result of the manipulations of currency depreciation by different countries.\textsuperscript{5} The accounting difficulties involved in recording these international transactions can be illustrated by the following case. Assume that Chinese import and export merchant in Shanghai purchased an order of machine parts from an American manufacturer in Chicago at a price of $10,000 United States currency. The invoice was billed in United States dollars, but in the books of the Shanghai merchant the record was shown in Chinese

\textsuperscript{1}M. S. Gordon, \textit{Barriers to World Trade}, pp. 40-41.
\textsuperscript{2}R. G. Thomas, \textit{op. cit.}, pp. 725-732.
\textsuperscript{3}R. P. Westerfield, \textit{op. cit.}, p. 227.
\textsuperscript{5}For dates of measures affecting exchange rates of all countries, 1929-1938, cf. M. S. Gordon, \textit{op. cit.}, pp. 40-41.
dollars at the official rate of exchange on the date of the invoice. Now assume that the Shanghai merchant did not cover this exchange risk by purchasing $10,000 United States currency, either spot or forward. Therefore, any difference between the book record and the amount of Chinese dollars required to purchase the necessary American dollars in order to liquidate the liability represents either a gain or loss on exchange fluctuation. This transaction would be an ordinary one if the following events did not take place during the course of the transaction. Assume that the purchase took place on April 10, 1933, when the United States dollar was on the gold standard. The shipment arrived in Shanghai May 15, at which time the gold standard of the United States was suspended. The bill was paid at June 6, when the exchange rate of the United States dollar was declining continuously. The exchange rates on these three particular dates were as follows. 6

<table>
<thead>
<tr>
<th>Date</th>
<th>Chinese Yuan</th>
<th>U.S. Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 10, 1933</td>
<td>Ch.$1.00</td>
<td>U.S.$0.2094</td>
</tr>
<tr>
<td>May 15, 1933</td>
<td>Ch.$1.00</td>
<td>U.S.$0.2444</td>
</tr>
<tr>
<td>June 6, 1933</td>
<td>Ch.$1.00</td>
<td>U.S.$0.2556</td>
</tr>
</tbody>
</table>

In the books of the Shanghai merchant, a liability of $47,755.49 Chinese currency was recorded on April 10, 1933, being the equivalent of $10,000 United States currency at

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6 New York Times, Financial Section, April 11, 1933, p.32; May 16, 1933, p.29; and June 7, 1933, p.39.
the exchange rate of U.S.$0.2094. At May 15, when the shipment arrived, the equivalent of $10,000 United States currency in Chinese dollars dropped to $40,916.53 Chinese currency. Again, at June 6, the date of payment, the equivalent in Chinese dollars dropped to $39,123.63 Chinese currency. A total difference of $8,631.86 Chinese currency occurred on account of the depreciation of the American dollar. The difference cannot be treated like the differences arising from ordinary fluctuations in foreign exchange rates. The differences from fluctuations are usually small and can be adjusted through the Exchange Adjustment account or Exchange Profit and Loss account. Because of the practices of currency depreciation by most of the countries of the world and the consequent violent fluctuations in foreign exchange rates, this method is unsatisfactory for dealing with considerable exchange differences. In order to distinguish the importance of the new situation, an Exchange Suspense account is introduced.\(^7\) The journal entries for the illustration are shown below:

(1) When the purchase was made on April 10, 1933, the exchange rate was 20.94 cents for one Chinese dollar:

Purchases.................. Ch. $47,755.49
Chicago Manufacturer........ Ch. $47,755.49

(2) When the shipment arrived at May 15, the entry was adjusted according to the rate of U.S.$0.2444:
Chicago Manufacturer........ Ch. $6,838.96
Exchange Suspense.......... Ch. $6,838.96

(3) When the invoice was paid at June 6, the actual amount of Chinese money spent to Purchase $10,000 United States currency was $39,123.63 Chinese currency at the rate of U.S.$0.2556. Another difference of $1,792.90 in Chinese currency was transferred to the Exchange Suspense account for adjustment and the account of Chicago manufacturer was closed:
Chicago Manufacturer........ Ch. $40,916.53
Cash......................... Ch. $39,123.63
Exchange Suspense......... Ch. $1,792.90

The Exchange Suspense account was left with a credit balance of $8,631.86 Chinese currency, which were held as a reserve. In case of an export transaction, the Shanghai merchant would suffer a loss as a result of the depreciation of American dollar. The loss would be carried accordingly to the Exchange Suspense account, a deduction of the gains from import transactions. The Exchange Suspense account, therefore, is an intermediate account used to record the differences caused from currency depreciation.
Besides the problem of recording the differences from currency depreciation, the rules for converting items for consolidation also need modification to meet the new situation. In 1936, Edwin L. Lopata made a survey of the consolidated statements of thirty American companies concerning their foreign exchange accounting policies. The methods used for converting balance sheets and disposing of exchange profit and loss varied widely from one company to another. The results can be summarized as follows:

(1) The bases of converting fixed assets and liabilities were more or less in line with the generally accepted practices, stated in Chapter IV of this paper. Fixed assets and liabilities were converted at the rates prevailing on the dates of acquisition. Reserves for depreciation on fixed assets were converted at the rates of conversion of the fixed assets.

(2) According to the general practice, current assets and liabilities are converted at the current market rate at the date of the balance sheet. However, exceptions were found for two reasons, viz.,

(a) A different rate, other than current rate,

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must be used in order to avoid the changes caused by currency depreciation.

(b) The impossibility of or the restrictions placed upon remitting funds from countries with foreign exchange control must also be taken into account.

The exceptions were:

(a) The National Cash Register Company converted its inventories abroad at dollar cost.9

(b) The Standard Oil Company of New Jersey gave the following statement.

"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."10

(c) The International Harvester Company stated:

"Pending the stabilization of international exchange, foreign net current assets (exclusive of goods of domestic manufacture held abroad, valued on a United


States dollar basis, and gold bullion, value at market) have been stated in terms of United States dollars on the basis of the exchange rates used by the companies at December 31, 1932, which rates were the prevailing market rates at that date of slightly lower. This basis of valuing foreign net current assets results in a conservative determination of current foreign earnings not transferred to the United States and excludes from the accounts all unrealized exchange appreciation since 1932. Exchange profits realized by the transfer of foreign funds to the United States and by the acquisition of gold bullion with foreign funds have been taken into earnings.\textsuperscript{11}

The purpose in doing this was to eliminate all unrealized market recoveries of exchange appreciation and all unrealized market recoveries of exchange write-downs made in 1932 and prior years.

(3) The bases for converting income and expense items were even more varied. Of the thirty companies, examined, seven of them used the current rate, three of them used average rates for the year, and the others used the following bases.\textsuperscript{12}

\begin{itemize}
  \item [(a)] Rates at which funds are transferred to New York
  \item [(b)] Canada at par - English subsidiaries at $4.3665.
\end{itemize}


\textsuperscript{12}Edwin L. Lopata, \textit{op. cit.}, p. 121.
(c) Prevailing rate monthly
(d) Average rate of remittances to United States
(e) Month-end rates
(f) Prevailing rates at end of quarter
(g) Weekly average rates
(h) "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."13

(4) As to the setting up of a reserve for exchange fluctuation, they had a comparatively uniform treatment, in order to carry both realized and unrealized gains and losses to the reserve account. Eastman Kodak, General Motors, Goodrich, and Goodyear, all adopted the following generally accepted practice - all losses, realized or anticipated, were deducted from income, realized gains added to the income, and unrealized gains were kept in a reserve until they actually materialized.14

The foreign exchange accounting policies of the thirty American companies covered in the survey are far from

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13Ibid., p. 121.
14Ibid., p. 125.
uniform. This variance was due to the nature of their businesses, to the various situations arising at different times, and also to their accounting policies. However, the survey did give a good picture of how the foreign exchange accountants dealt with the problem of currency depreciation during the period 1931-1935.

Exchange control is not new, it was employed early in the sixteenth century in England. Its widespread adoption, however, did not come until July, 1931, when Germany began to control foreign exchange transactions. Hungary followed a week later and, by the middle of October, Chile, Uruguay, Colombia, Greece, Czechoslovakia, Bolivia, Yugoslavia, Latvia, Austria, Finland, Argentina, Norway and Iceland had taken the same action. Denmark, Estonia, and Nicaragua had established similar controls by the end of November. In spite of these followers, Germany remained one of the outstanding representatives of exchange control policies, which had an increasingly complex development. By the beginning of 1939,

"a general recodification of all exchange-control regulations came into legal effect for Great Germany. Since its inception in the crisis of July, 1931, 'modern money' had required three general exchange-control laws, upwards of 50 separate decrees of amendment and adaptation, and something in the neighborhood

\[15\] M. S. Gordon, Barriers to World Trade, p. 52.

\[16\] Ibid., pp. 54-55.
of 500 administrative rulings, to say nothing of clearing, compensation, and payment agreements with partner countries. 17

The techniques of exchange control are usually: to compel all exporters and owners of foreign currencies to sell their foreign currencies or claims to the central bank or exchange control board at a fixed price; to compel all importers and persons who need foreign exchange to get permission from the central bank or exchange control board (or other authorized organizations); to purchase exchange at a fixed price; to prohibit the outflow of capital held by foreigners; and to establish a scale of rates designed to indicate the relative importance of the different types of foreign payments. 18 By adopting a system of exchange control in many cases the foreign exchange market practically ceased to function.

Transactions with countries where there are exchange control systems require, therefore, special care and attention. From the accounting point of view, the businessmen have to know the main provisions of the exchange control laws prevailing in the countries with which transactions are carried on, so that their financial statements can be best prepared with information most close to the fact. It is a

17 H. S. Ellis, Exchange Control in Central Europe, p. 166.

18 M. S. Gordon, op. cit., pp. 64-85.
difficult task, however, if transactions are carried on without a knowledge of the particular exchange control laws in ruling, and lack of knowledge will invite loss. The following cases illustrated the importance of this factor.

(1) In the countries where there are exchange control practices, the debtors can secure discharge of a debt owing to foreign creditors by paying local currency to the central bank of their countries on account of their foreign creditors, regardless of the fact that the debt was originally contracted in foreign currency. Furthermore, the exchange rates are set up artificially by law to empower their nationals to convert foreign currency obligations into local currency at a favorable rate at the expense of foreign creditors.

(2) The deposits of foreigners in the banks of countries with exchange control systems are generally restricted by law to limit free withdrawal. The foreign depositors may not even be able to use them to settle the personal debts they may have in their own country. The term "blocked accounts" is used. Foreign depositors can sell their blocked accounts at discount.

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20 Ibid., p. 18.
(3) The countries with exchange control systems generally have several types of currency, each being used for a definite purpose. In dealing with such foreign currencies it is important that an accountant should know in what type of currency he is dealing.

(4) Many exchange-control countries have a system known as "compensation," which permits an importer to cover his foreign exchange requirements by approaching an exporter who has foreign exchange. The importer has to pay the exporter a higher rate as a premium. Therefore, for accounting purposes, the conversion of the currency of a country with a compensation system should make allowance for the additional charge.

The above cases illustrate but a few of the complexities of the foreign exchange problem. In order to deal with the disturbed conditions, the Committee on Accounting Procedure of the American Institute of Accountants, suggests the following general treatments of foreign exchange transactions:

(1) To revenues,

"a safe rule for United States companies to follow would be that in their own accounts earnings from foreign operations for the current year should be

23 American Institute of Accountants, Accounting Research Bulletins No. 4, December, 1939.
shown only to the extent that actual remittances for them had been received in the United States. Provision should be made also for known losses of subsidiaries."

(2) To assets abroad,

"the accounting must take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned."

(3) To financial statements,

"it is important that especial care be taken in each case to make full disclosure in the financial statements of United States companies of the extent of foreign items there included."

(4) To consolidation,

"to exclude foreign subsidiaries from consolidation and to furnish: (1) statements in which only domestic subsidiaries would be consolidated; and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The aggregate amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated."

(5) To gains and losses on exchange,

"realized losses or gains on foreign exchange should be charged against or credited to operations. Provision for declines in conversion value of foreign net current and working assets should be made and shown separately."

From the study of the above rules, it is clear that there is no rigid method for dealing with currency depreciation and exchange control problems. Therefore, it is advisable to adopt a sound conservative accounting practice. To set up a higher reserve against foreign exchange fluctu-
ations, foreign currency depreciation, exchange control and other contingencies is the method adopted by most of the leading American industries. The reserve is composed of two elements:

"one being the amount which the company is reasonably likely to sustain as a loss during a future period not to exceed one year; based upon past experience as to transfer of funds, the other being a purely theoretical loss which will in all probability never be suffered. In the case of the former, it would, in the writer's opinion, be entirely justifiable to set up as a 'current liability.' The remainder should be stated as a contingent liability and be offset in equal amount on the asset side by a deferred charge item brought down among the intangible or other assets." 24

In terms of actual business practice, the following illustrations are indicative:

(1) The Eastman Kodak Company

"In recent years, the company has deemed it advisable to maintain these reserves against the possibility of losses of one sort or another resulting from the world-wide operations of the company. In view of the unsettled conditions in the world today, your directors have authorized the transfer of $1,500,000 from earned surplus to the credit of reserve for contingencies." 25

(2) E. I. du Pont de Nemours & Company

"Securities of foreign companies are included in the consolidated balance sheet at approximately $20,200,000......the sum of $2,700,000 was charged against income to provide a reserve against the


contingency of loss on the investment in securities of companies located in France and Germany. 26

(3) International Harvester Company

"The revaluation resulted in a decrease of $6,831,000 which was charged to Reserve for Foreign Losses and Exchange Fluctuations, thereby reducing the balance in this reserve from $14,056,000 at October 31, 1938 to $8,228,000. This balance was increased by a charge to Income account of $2,500,000, representing approximately that portion of the 1939 net income of foreign subsidiary companies and branches which is not readily remittable to the United States, principally because of exchange restrictions. In order to provide further for the increased hazards abroad, a rearrangement of the general reserves of the company was made whereby $9,500,000 was transferred from Special Maintenance Reserve through the Surplus account to the Reserve for Foreign Losses and Exchange Fluctuations, bringing the balance in the latter account at October 31, 1939 to $20,225,000." 27
CHAPTER XII

CONCLUSION

The chief characteristic of foreign exchange accounting is that it entails the exchange of one currency into another. The owner of business always look at transactions in terms of currency of their own country. In their minds, they would instinctively try to convert the transactions in foreign currency to their equivalents in home currency, because foreign currency can not circulate as the home currency does in the country of the owners of the business and because the final profit or loss on the foreign exchange transaction can be determined only after the foreign currency is converted into home currency. In other words, they generally considered their home currency as the stable currency and foreign currency with which they do business as the fluctuating currency. Before the gold standard was abandoned, the fluctuation of exchange rates was limited by the gold shipping points. But, later, after the abandonment of the gold standard by many countries, the fluctuation of exchange rates was within very wide limits. Many governments took advantage of the new situation and depreciated
the value of their currency, in order to encourage their exports and discourage their imports, by employing artificial methods. The fluctuating rate of foreign exchange became so rapid and violent that no business man could foretell the value of the foreign currency with which he did business. For instance, the value of French francs in January, 1919, was 18.35 American cents per franc, but dropped to 8.475 in January, 1920. In January, 1936, one French franc was the equivalent of 6.6251 American cents; but in January, 1937, 4.6672 cents; and in January, 1939, 2.6369 cents. The increasing uncertainty of the foreign exchange rate, as a matter of fact, will bring with it increasing uncertainty of the profit and loss of the foreign traders or investors. Moreover, a new responsibility is assigned to the accountant for dealing with the conversions and exchange differences or profits and losses. Accounting methods used for this purpose differ in accordance with the nature of the business.

(1) **Foreign Traders** - Importers and exporters who reside in their own country and do business with foreign countries have to establish an adjusting account, Exchange Adjustment account, for the adjustment of the differences between the amount they have estimated to pay or to receive and the amount they have actually paid or received. For hedging transactions, Exchange Futures Purchased and Exchange Futures Sold accounts are established.
(2) Foreign Investments

(a) Foreign Agencies - Accounting records for foreign purchasing or selling agencies generally are kept in the books of the home office. Accounting procedures will be simple if purchases and sales are billed in home currency. But if they are billed in foreign currency, the problem is complicated. Columns are needed in the sales book, purchases book, accounts receivable account, accounts payable account, and cash books, for the following information: foreign amount, exchange rate, home currency amount, loss on exchange, profit on exchange, etc.

(b) Foreign Branches - As an individual unit, the branch books are kept in terms of the foreign currency and separated from the books of the home office. Inter-office transactions which are recorded in one currency on one set of books must be recorded at an equivalent amount in the other currency on the other set of books. Inter-office cash transfers are recorded in Remittances accounts in order to provide reciprocal accounts showing both the foreign currency amount and home currency amount. At the end of the fiscal period, the branch profit which is computed on the branch books in the foreign currency should
be recomputed in the domestic currency and be taken up on the home office books. Balance sheet and profit and loss statement should be converted into home currency and consolidated with the statements of the home office. Current assets and current liabilities are generally converted at the rate of exchange prevailing on the date of the balance sheet. Fixed assets and long-term liabilities are converted at the current rate at the time when the assets were purchased or the liabilities were actually contracted. Profit and loss items are converted at the average rate for the period.

(c) **Foreign Manufacturing Plants** - The construction costs of a manufacturing plant in a foreign country are determined as follows:

(i) labor costs should be converted at the average of the daily rates of exchange prevailing during the period,

(ii) material costs should be converted at the time when they were purchased,

(iii) exchange profit and loss on funds which are set aside in a foreign country for construction purposes should be handled as follows. In case of loss it should be
written off to the revenue account, and in case of gain it should be deducted from the cost of the plant.

Inter-office accounts are kept in both currencies, the same as in the accounting procedure for foreign branches. The costs of raw materials or semi-raw-materials and working funds may be computed on the first-in first-out theory.

(d) **Foreign Subsidiaries** - Foreign subsidiaries are organized as separate companies and incorporated under the laws of foreign countries. They are carried in the Foreign Investments account during the accounting period. Their statements may be consolidated with the statements of the parent company at the end of the accounting period. But, in actual practice, most of the companies consolidate only their 100% owned foreign subsidiaries. Large reserves for emergencies are usually set up in order to deal with insecure international political and economic situations.

(3) **Foreign Exchange Banks** - Foreign exchange dealers and banks serve as middlemen to bring the demands for and supplies of foreign exchange together at the market. The accounts they carry can be
classified as either commercial or trading.

(a) **Commercial transactions:**

"Due from Foreign Banks and Bankers" or "Nostro" account serves as an inventory account for foreign exchange on hand. The account is kept in both home and foreign currencies. The differences between the selling price and purchasing price of foreign currency are profits and losses on exchange transactions. Purchases of foreign exchange generally occur through the process of collections, discounts, purchases of foreign bills, etc. The proceeds are credited to the Nostro account when they are collected. Sales of foreign exchange generally arise through the process of selling demand drafts, cable transfers, travelers' checks, etc. The amount for each sale is debited to the Nostro account. In the case of commercial letters of credit, the contingent liability of the bank should be recorded to the credit of Commercial Letters of Credit Issued account and debited to Customers Liability under Commercial Letters of Credit account.

(b) **Trading Transactions:**

Position sheets, which are used to classify foreign balances that constitute the bank's stock
of foreign exchange, are the guide for the trader. They can be classified into cable position sheet, 30-day position sheet, 60-day position sheet, etc. Their chief use is to inform the trader how the inventory stands during the different periods. Then the trader, who is thoroughly informed about the position of the bank, is able to take advantage of market conditions for arbitrages, speculations, and investments. The general principle for the trader is to buy foreign currency more cheaply than he previously sold it.

The accounting process can be simplified and exchange differences can be avoided by adopting a new accounting method, that is, to record the transactions in the currency in which the business is carried on and to use the Exchange account as a clearing account for the foreign and domestic currencies. This is practicable for business firms having many foreign exchange transactions, especially for a foreign exchange bank or dealer, but this plan would be too costly if the business enjoys but few foreign exchange transactions during the year. Exchange differences from exchange fluctuation can be avoided in the books; profits and losses caused by currency depreciation and exchange control systems can be recorded by conservative accounting methods; but the real risks in international trade, arising from these factors, are
always there and can not be eliminated by accounting pro-
cedures.

The World Monetary Conference at Bretton Wood, N.
H., in 1944, proposed the following measures to stabilize
the currencies of the world.¹

(1) A world monetary fund of $8,800,000,000 to be
pooled for the purpose of the settlement of inter-
national accounts through bookkeeping transfers
instead of shipping gold.

(2) Fund members to be allowed to reduce their cur-
rencies by 10%. A second 10% depreciation could
be taken if the first did not work, unless vetoed
by the committee.

(3) Fund members to agree to stop using exchange con-
trols, currency blocs, import quotas, etc.

If the above plan can be put into practice after the war,
it will give some confidence to international business men
that they will be paid or charged in a medium of relatively
fixed value. Fluctuation of foreign exchange rates will
thus be limited, and the risk in foreign exchange trans-
actions is reduced as compared with that before the war.
The international trade of the post-war period should be
encouraged by all means, as it is the chief means whereby
the world can recover and prosper. Foreign exchange ac-

¹United States News, Washington, D. C., July 28,
1944, pp. 22-23.
counting will then have more applications and hence a larger development.
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BIOGRAPHY

The author was born in Tientsin, China on January 9, 1917. He came to the United States in September, 1933, after he obtained his B. A. degree in Commerce from Nankai University, Tientsin. He registered at the University of Pennsylvania, immediately upon his arrival, and majored in International Trade. In the Spring of 1940, he received his M. A. degree from that institution. After three months practice in the Irving Trust Company, New York City, he joined the Foreign Exchange Department of the Bank of China, New York Agency, New York City. In the Summer of 1942, he was awarded a scholarship from the State Department, Washington, D. C. He registered in the Graduate School of the Louisiana State University in September, 1942, and is a candidate for the degree of Doctor of Philosophy at the Spring Commencement in May, 1945.
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Major Field:  Accounting

Title of Thesis:  Foreign Exchange Accounting

Approved:

[Signatures]

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination:

May 10, 1940